October 1957

THE CANADIAN CHARTERED ACCOUNTANT

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

HOW D.B.S. SERVES THE NATION

A review of Canada's central statistical agency and its aids to industry

Modern Approach to Auditing

Chartered Accountant's Role as Business Adviser

Preparing an Accounting Manual for a Company

Pitfalls in Tax Compliance

Direct Costing

ACCOUNTING RESEARCH: Classification of Assets

TAX REVIEW: Interest Paid

THE CANADIAN
CHARTERED ACCOUNTANT

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IN THIS ISSUE

S. A. GOLDBERG (page 309)

Businessmen interested in a realistic discussion on the usefulness of statistics will want to turn to S. A. Goldberg's article "How D.B.S. Serves the Nation". As the title indicates, the author has taken a close look at the work of Canada's central statistical agency and considers how statistical information can be brought to bear on the needs of management. The author's challenging assertion of the evolution of a satisfactory statistical system is a grand exercise in cooperation between D.B.S. and the business community and should be of interest to every reader – particularly in times like these when the nation's economy is becoming more and more complex and industry has to face so many challenging situations.

Mr. Goldberg is Assistant Dominion Statistician and as such is well acquainted with the potentials of statistical reporting as well as their limitations and the problems involved in collection. He joined the Dominion Bureau of Statistics in 1945 as national income statistician and worked on the reorganization of D.B.S. statistics to make them more suitable for the regular publication of the national income and expenditure accounts. Later, as director of the Research and Development Division, he was responsible for the publication of the "National Accounts", "Indexes of the Physical Volume of Production", "Income Size Distribution", and similar studies. He graduated in economics and political science from McGill University and obtained his Ph.D. in economics at Harvard.

H. I. ROSS, C.A. (page 323)

Over the past 50 years there has been a gradual change in the nature of auditing. The growth and complexity of corporations have meant a shift from what was essentially a meticulous routine check to a highly skilled appraisal of business transactions. "The Modern Approach to Auditing" sums up the thoughts of Howard I. Ross who discusses the changing nature of the audit and deals with a number of basic issues with which the accounting profession is faced. This is the first of a two part article adapted from a paper presented at the C.I.C.A. annual conference held recently in Saskatoon.

Mr. Ross is a partner in the firm of P. S. Ross & Sons, Montreal and vice-president of the Institute of Chartered Accountants of Quebec. He has been a frequent contributor to this journal.

WALTER L. GORDON, F.C.A. (page 315)

One of the country's top businessmen – widely known as the head of the Royal Commission on Canada's Economic Prospects – gives the profession the benefit of his experience as a chartered accountant involved in the field of management consulting. In "The Chartered Accountant's Role as Business Adviser", Walter L. Gordon, partner in Clarkson, Gordon & Co. and president of J. D. Woods & Gordon Ltd., Toronto, Management Consultants, writes of the trend towards specialization for members of the profession whether it be in accounting, auditing, taxation or management consulting. Mr. Gordon explains it this way: "Even the small practitioner can specialize and feel perfectly free to call in other specialists to help him when he needs assistance. Great expansion will take place in the resource industries, particular-

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ly in oil and gas, the generation of electric power and mining; there will be a great expansion also in secondary manufacturing and in the service industries. All this will call for more people with specialized training, more people with diversified experience, and more people who have learned to think clearly, objectively and in broad terms. The profession faces a great challenge and tremendous opportunities."

Since the mid-twenties, Mr. Gordon has fulfilled a number of significant government and industrial assignments. He assisted with the organization of the Foreign Exchange Control Board at the outbreak of World War II and from 1940 until 1942 was special assistant to the Deputy Minister of Finance. Later he headed the Royal Commission on Administrative Classifications in the Public Service and, in 1955, he was appointed chairman of the Royal Commission on Canada's Economic Prospects, which recently published its interim report.

H. O. McNUTT (page 330)

Any business regardless of its type or size needs a good foundation and there is no surer method of achieving this than by the use of a well prepared accounting manual to enable management to interpret more easily the constant changes in its condittions. According to Harold O. McNutt in "Preparing an Accounting Manual for a Company", its preparation does not need to be elaborate and a small business may find as many advantages for its use as a larger company. In his article, the author reviews some of the procedures to be followed in preparing an accounting manual and explains how, to be fully effective, some form of

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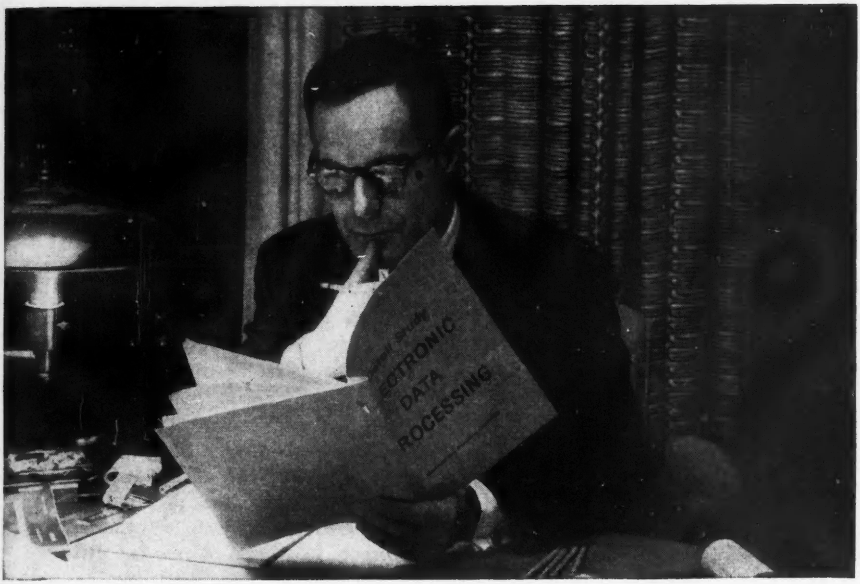

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periodic revision procedure should be kept in mind.

Mr. McNutt is a member of the Board Committee of Imperial Oil Limited studying potential uses of mathematical techniques and electronic data processing. He was formerly co-ordinator of refinery accounting for Imperial's nine refineries and undertook special systems studies in refinery accounting. He joined Imperial Oil Limited in an accounting capacity nearly 30 years ago.

T. A. M. HUTCHISON, F.C.A. (page 337)

Taxpayers will find occasionally that some particular condition or situation in their business makes them liable for income tax where no liability to tax should exist. Sometimes this may arise from the lack of any special provision in the Act to deal with the particular situation; at other times it may be caused by some specific provision of the Act. The problems involved in tax compliance apply to individuals as much as to corporations, but in "Some Pitfalls of Tax Compliance", T. A. M. Hutchison deals mainly with the latter group when he discusses a number of important provisions in various sections of the Act and comments upon their inequities. This paper was presented during the summer at the Tax Seminar at Queen's University, Kingston, and is reprinted by kind permission of the author with a view to reaching a wider public.

Mr. Hutchison is senior partner of Peat, Marwick, Mitchell & Co., Toronto, and a former chairman of the board of governors, Canadian Tax Foundation. He retired last month after serving for five years as treasurer of the Canadian Institute of Chartered Accountants and was recently appointed Chairman of the Institute's Committee on Accounting and Auditing Research. Mr. Hutchison has had wide experience in matters relating to the Canadian Companies Act and the Ontario Securities Act, having served on committees set up to study the provisions of both these Acts.

ALPHONSE RIVERIN, C.A. (page 345)

While some companies confirm that the direct costing system more than adequately meets their needs from an accounting standpoint, others declare that it does not appear to have any clear advantages and that organization within the company and internal reporting can be obtained by using conventional cost methods. In "Direct Costing", Alphonse Riverin explains what direct costing is and introduces the reader to some of the advantages and disadvantages connected with this controversial issue.

Mr. Riverin obtained his M.B.A. (New York University) and Master in Social Sciences (Laval University) and in 1955 was admitted as a member of the Institute of Chartered Accountants of Quebec. He is assistant professor of accounting and finance at Laval University, Quebec City, and secretary of the accounting department of the school of commerce. He acts also in a consulting capacity to firms involved in labour relations and cost accounting problems.

EDITORIAL (page 307)

The recent publication by the Canadian Institute of Chartered Accountants of "Accounting Terminology" brings into the spotlight the fact that many errors and much confusion in accounting are a result of the misapprehension of the language. This month's editorial, contributed by William G. Leonard, F.C.A., throws

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further light on the problem and suggests how accounting terminology as a language can attain much greater significance. There remains the need to see that pertinent information required by management to make sound decisions is not discarded because it was either misunderstood or couched in terms inconsistent with the facts and realities of commercial life.

Mr. Leonard, a partner in the firm of England, Leonard, Macpherson & Co., Kingston, is director of professional courses in the School of Commerce at Queen's University. A frequent contributor to *The Canadian Chartered Accountant,* he is well known for his articles and as coauthor of "Canadian Accounting Practice". His new book, "Canadian Income Tax for Accountants", will shortly be published by CCH Canadian Limited.

NOTES AND COMMENTS

C.I.C.A. Taxation Committee

Harold E. Crate, chairman of the C.I.C.A. Taxation Committee, reports that the committee will shortly be preparing the Institute's recommendations which annually form part of the joint brief on taxation submitted in conjunction with the Canadian Bar Association to the Minister of Finance.

Ordinarily recommendations are received from the Provincial Institutes, but the committee also welcomes suggestions from individual members as to desirable amendments to the Income Tax Act and Excise Tax Act. Correspondence should be addressed to the Taxation Committee, Canadian Institute of Chartered Accountants, 69 Bloor Street East, Toronto 5. All suggestions received by October 31 will be considered.

"Financial Reporting" 1957

A new and expanded edition of "Financial Reporting" will be published by the C.I.C.A. Committee on Accounting and Auditing Research this fall. It represents the results of a study of the annual financial reports of 300 Canadian companies and shows a four-year comparison. Combining statistics with commentary, as in the original 1955 edition, "Financial Reporting" is intended as a handbook for both the practitioner and the industrial accountant. Copies will be available to members at $4.00, to others at $5.00.

Forest Taxation

A study on the economic effects of taxation and of the regulating of Crown forests by the provinces has been published by the Canadian Tax Foundation. This 315-page brochure, designated as "Forest Tenures and Taxes in Canada – Tax Paper No. 11" and written by A. Milton Moore, is the culmination of over two years intensive research and is by far the most ambitious project of its kind ever attempted for a natural resource industry in Canada. Even in the U.S. nothing similar has been undertaken in recent years. The study, which costs $3.00, is available from the Canadian Tax Foundation, 154 University Ave., Toronto 1. Special discounts are available for bulk orders.

More for Less

Canadians are being paid more for working fewer hours each year, says a report by CCH Canadian Limited. Since 1945 hourly earnings in manufacturing have increased 118.3% while the average hours worked have decreased 7.2%. A similar trend is shown in all major industries except construction, which is still faced with considerable overtime hours. In 1956 the average weekly wage in manufacturing was $62.27, compared with $30.74 in 1945.

By province, Saskatchewan shows the highest gain in hourly earnings – 131% – largely because of the growth

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of petroleum refining in that province. Nova Scotia is the lowest with 88%.

Internal Auditing Courses

During the 1957-58 academic year, two courses in internal auditing will be presented by the Toronto Chapter of the Institute of Internal Auditors in conjunction with the University of Toronto. A basic course, starting October 8 for 10 lectures, will cover the nature and objectives of internal auditing, purchasing, payments and cash disbursements, payrolls, finished goods – production and sales, receivables and credit, cash receipts, fixed assets and company records. Commencing on January 7, 1958 an advanced course will be presented for those seeking advanced knowledge in internal auditing on a managerial level. Topics will include the internal audit approach to existing controls, organization and techniques of internal auditing, capital expenditures, branch office and factory audits, fraud, and reporting and management action. The fee for each course is $15, or both courses may be taken for a combined fee of $25. Further information and application forms are obtainable by writing The Director, University Extension, University of Toronto, 65 St. George Street, Toronto 5.

New Canadian Encyclopedia Issued

More than 800 scholars and writers have contributed to the new 10-volume Encyclopedia Canadiana, the first volume of which has just come off the press. The encyclopedia contains more than 3,000 detailed articles of a geographical and historical nature; 3,000 biographies and numerous special articles on all aspects of Canadian life, such as national income, foreign trade, labour organizations, transportation and banking. Published by The Canadiana Co., it has enjoyed a pre-publication sale of 2,000 sets at $103.50 each.

In the News

JAY WALDO MONTEITH, F.C.A. (Ont.), has been named Minister of Health and Welfare by Prime Minister John Diefenbaker. Senior partner of the firm of Monteith & Monteith, Stratford, Ontario, the Hon. Mr. Monteith has played an active part in public life for some years. He was an alderman in Stratford from 1939 to 1941, becoming mayor in 1944 and 1945. In 1953 he was elected to the House of Commons for the riding of Perth. His father was Provincial Treasurer and later Minister of Labour in the Ontario Government and his grandfather served both in the Ontario Legislature and in the House of Commons.

Editorial

THE LANGUAGE OF ACCOUNTANTS

ANY OCCUPATION of man that is related to an extensive theoretical and conceptual framework tends to develop variations or modifications of the English language that are peculiarly its own. Both practitioners and teachers must recognize as an occupational hazard the constant temptation to disguise the lack of a fresh or a firm viewpoint by the use of specialized language that can be nicknamed "jargon". The over-development of jargon is a luxury that practising accountants can ill afford as their effectiveness depends upon their ability to convey information to the businessman or "man on the street".

The preface to "Accounting Terminology" advances the opinion that "accountants have, with considerable success, resisted the development of jargon, in spite of popular misconceptions to the contrary. Few if any words can be found that are wholly accounting in their usage, and it is safe to say that the accounting usage of words rarely offends their customary sense". The unfortunate exceptions, such as the widespread misuse of the word "reserve", are becoming recognized and remedial action is being taken. Even in the case of the word "reserve", the accountants have not sinned alone but in the company of the legal profession and of the law courts, and may even have been led by them from the path of virtue.

Accountants, in developing methods of financial statement presentation, have developed an effective technique that serves the purpose of compressing financial information of considerable variety and scope into an amazingly small package. It would be difficult to find any other kind of document where such a small number of words and figures can be made to yield so many meaningful disclosures in the hands of a sufficiently sophisticated reader, particularly if the reader has access to the financial statements in historical series over a number of successive years.

This technique of compressing the financial results of a multitude of transactions into each separate dollar total shown as a single figure in a financial statement is accompanied by dangers as well as convenience. Let us consider, for example, one of the simplest descriptions used by the accountant in a truly informative financial statement, namely the figure representing sales for the year. This is probably the simplest description in the document and the one that a reader is least likely to misunderstand. It is a single figure, described by a single word. In order to total in this simple fashion the similar aspect of hundreds or thousands of transactions, all dissimilarities are, for this purpose, ignored. The items are lumped together and the total is labelled with the single word "sales". The reader is left to surmise that certain deductions will have been made for such things as returns and allowances, and is left in the dark as to whether or not such items as freight and cartage on outward shipments will have been deducted in producing this total.

So the accountant, in order to produce the grand simplicity of a meaningful result, must always be engaged in the task of culling out those dissimilarities which he deems insignificant for his purposes in order to produce the desired summarization of similarities that he decides are meaningful for his purposes. The forming of judgments as between dissimilarities that may safely be ignored and those which must be highlighted in any fair presentation is a task of some difficulty and often of extreme delicacy.

The accountant is engaged in a constant struggle to achieve both brevity and clarity in his reporting. Unless his reports are brief, they cannot be clear; however, they may be too brief and, hence, unclear. If the accountant's reports are wordy, few people will bother to read them. Those who do persevere in wading through the mass of detail will lose the effect of any intended emphasis on salient features. On the other hand, it is fatal to achieve brevity at the expense either of clarity or accuracy. A report that is brilliantly misleading is plainly a worse offence against professional competence and probity than a report that is dull but harmless.

How D.B.S. Serves the Nation

S. A. GOLDBERG

As CANADA'S central statistical agency, the Dominion Bureau of Statistics serves many groups in the national economy, including the federal and provincial governments, municipalities, labour groups, educational and other institutions, and, in a significant way, industry.

The growing interest in statistics arises basically from the same factors that are responsible for the increasing interest in scientific management and technological improvements. In the last analysis, interest in these matters is sustained by an awareness that attention to them should pay off. Indeed, in many circumstances concern about them has ceased to be a matter of choice and has become a necessity for economic survival.

Business Yesterday and Today

Years ago, in the days of the kerosene lamp and horse-drawn carriage, the requirements for statistical data were limited. The individual enterpriser dominated business affairs and his terms of reference were circumscribed. The typical markets were local and the range of production narrow. Changes in the methods of production were slow to come about. It was not too difficult in those days to become a "jack-of-all-trades", combining adequate personal knowledge of sources of supply and suppliers, markets and customers, and the "labour force". Acting on hunches and guesses was common, and it could be assumed that competitors were not deriving substantial advantage by being better informed about what was happening outside their immediate business environment.

Rapid industrialization changed the face of business drastically, bringing with it the era of the impersonal corporate form of business organization and mass production. The division of labour in business affairs became immensely more complex, challenging the ingenuity of those in charge of coordination of the various activities. The range of output increased tremendously, making it necessary to keep abreast not only with one or several markets but with the inter-related markets of a large number of distinct commodities. The markets themselves were transformed by various advances in transportation and communication. This raised potential sales horizons to national and even world-wide dimensions. At the same time, it made import competition, in many industries, an important

consideration in formulating production and sales policies. The possibility of rapid obsolescence of existing machinery and procedures became an ever-present and disconcerting threat. New and major uncertainties thus appeared in the conduct of business affairs, and long-range, as well as short-range, business planning became essential to successful management.

The features just described have become increasingly typical of the Canadian economy, especially during the post-war years. To maintain a prosperous enterprise in our complex, interdependent and dynamic economy of today, it has become necessary, to an increasing extent, to base business decisions on a very broad knowledge of demand, supply and cost conditions. Such knowledge must be much wider, more varied and formidable in range than it is possible to acquire by personal observation and experience alone.

Need for External Data

Much of the information required for managing a business comes, of course, from its own books. These are usually designed to answer questions concerning internal operations, such as: Is the business yielding a profit? Is the ratio of profits to sales satisfactory? Are sales and profits going up or down? Are inventories being depleted or are they piling up at an abnormal rate?

However, even the most elaborate accounts of an individual firm can only go so far in answering questions of a type that have to be posed repeatedly in a modern business. In large firms, in particular, the point is quickly reached where it becomes necessary to supplement the information derived from internal accounts with external data. In the first place, it is not enough to know that sales, profits, inventories or costs of a firm are going up or down. It is important to know also whether they are moving as fast as those of competing firms. Secondly, challenging questions have to be faced as to the kind of policies to adopt in relation to suppliers of materials and labour. Are supplies likely to become overabundant or may shortages develop? What is the outlook for prices of materials? Are demands for wage increases reasonable? Thirdly, there are a host of questions which must be considered regarding the marketing of products. Should branches be opened in hitherto untapped territories? In view of the changing composition of the population, would it be wise to get into production of new or related products? Is full advantage being taken of the potentials of certain marketing outlets?

Questions of this sort are difficult, and there are no hard and fast rules for answering them. Much reliance must necessarily be placed on general knowledge, practised intuition and personal skill and judgment. But the study of quantitative data, reflecting the relevant "outside" factors which might intimately affect the outcome of any decision, is necessarily involved. The area of sheer guesswork can be narrowed down substantially if quantitative information of the type produced by agencies such as the Dominion Bureau of Statistics can be secured and brought to bear on the questions at hand. Information of this sort distils a myriad of facts into manageable summaries and, when properly presented, can display relevant relationships in a clearcut way. These summaries can be used as points of orientation and a framework within which problems

can be explored and specific decisions worked out. Thus, the work of accountants and that of DBS statisticians has a common meeting ground in the needs of management. What the DBS does on a national basis is complementary to what accounting departments do for individual firms.

The increasing realization that statistics are necessary in the management of business reflects itself in pressing demands on the DBS by business firms and associations for more statistics, more timely statistics and more detailed statistics. Fortunately, just as industrialization has called forth a strong demand for factual data, so has it facilitated the satisfaction of this demand. Thus, mechanization has made possible the production of data on a much vaster scale and much faster than would be feasible by hand methods. The wider incidence of the arithmetic literacy of the population and, in particular, the widespread use of accounting – to a large extent concomitants of industrialization – have created favourable conditions for the production of a whole range of statistical series which in their absence would have been difficult or impossible. At the same time, the presence in Canada of a central statistical institution has been conducive to maintaining balance and order in the ensuing growth. Indeed, the DBS must allocate its scarce resources with due regard to the demands for its services from all quarters of the nation. Further, new requests for statistics must be weighed carefully against additional burdens they might cause respondents.

Interpretation of Statistics

It must be emphasized that statistics, like the books of a firm, are no more than tools – they are aids to judgment. In a fundamental sense, the decisive factor in the successful use of statistics is the person using them. He must be able to interpret them objectively, that is reason from them in a genuine effort to seize hold of the real factors at play, casting aside temptations to support wishful thinking; and to appraise them critically, that is recognize the purposes they are designed to serve and their limitations in the light of these purposes.

To illustrate, among the most widely used statistical reports are the publications on expenditure on new capital assets that various firms plan to incur in the year ahead. These figures are shown in considerable industrial and regional detail. The changes in size of the intended capital outlay in the various industries and localities from year to year serve as a valuable indicator of the outlook of management, but the user of the data must keep in mind that the statistics represent plans or intentions *as at a certain point of time.* As a result of changes in business climate, availability of labour, materials or finance, or indeed the data presented in the reports, these plans or intentions might change in the subsequent weeks or months. The divergence between the initial intentions and actual realizations at the year-end might be considerable. In recognition of this, the DBS conducts a mid-year check-up survey and publishes a report on revised intentions but, in addition, users would have to study relevant monthly indicators and other current information in order to avoid basing decisions on situations that have become obsolete.

As practising accountants will be aware, statistics do not always con-

form exactly to the definitions laid down in questionnaires. Aside from imperfections that may arise from ambiguities of language or sheer misunderstanding of the written word, inaccuracies occur because some firms record identical transactions in different ways while the DBS must of necessity define the various categories in a uniform way. For example, the questionnaire on capital expenditures requests that outlays for used machinery and equipment, and land should be excluded. The reason for this is that major interest lies in new capital assets which add to productive capacity, rather than in domestic transfers of second-hand capital goods which existed previously. However, some firms may have difficulty in making this distinction with the result that the published totals contain some estimates, the accuracy of which depends on how carefully these estimates were made. It should be noted that in the course of adding up the data there is usually a great deal of cancellation, leaving net errors which are of much smaller overall significance. Further, the DBS has evolved careful editing and checking procedures which aim to uncover and correct the more important discrepancies.

Industrial Classifications

A statistical series is usually used in conjunction with some other series. Statistics in related fields should therefore be as comparable as possible. With this in mind, the DBS makes use, for example, of the *standard industrial classification*, which sets down precise "industry" boundaries so that figures relating to particular industries can be classified uniformly for study and analysis. In general, the accepted convention is to allocate plants to the industry to which their major products belong. This convention has been adopted in recognition of the fact that many firms do not keep detailed records on a smaller basis, such as departments within plants. However, difficult reporting problems arise even on a plant basis. For example, a firm having separate operating plants assigned to different industries may maintain inventories in a common warehouse, and a problem of allocating the inventories as between the several industries might arise. When cases of this sort are brought to the attention of the DBS, satisfactory reporting procedures can usually be worked out in cooperation with the firm but, at times, an interval may elapse before the problem comes to the surface. In the meantime the published totals may contain imperfections as a result of faulty allocation.

Problems of Accuracy

Fortunately, for most business purposes reasonably good approximations, rather than magnitudes of dollar and cent accuracy, are required. Statistics are frequently used to form impressions regarding what people's future actions might be. The past is usually studied in order to come closer to the mark in anticipation of the future. In such use of the figures the user must make assumptions of how the future will resemble the past, and the errors that the statistics contain are probably less important in the final result than inaccurate assumptions.

While the problem of accuracy must be seen in perspective, in relation to the purposes the data are designed to serve, the relative importance of the magnitudes in-

volved and the cost of improvement, in actual practice the statistician's major task is to ensure that the data reflect and do not distort the real trends and situations they purport to represent. It is a constant challenge to the DBS to maintain its statistics at the required level of accuracy and to bring them out promptly. In a sense, timeliness is an aspect of accuracy where the data are used for current analysis, because the shorter the interval that elapses between a development and the release of data relating to it, the greater are the chances that the data are relevant to the current situation.

Aside from careful editing and checking procedures and attempts to clarify definitions and simplify instructions, various other measures have been implemented by the DBS in recent years to promote accuracy and timeliness. In particular, the questionnaires and collection procedures are under constant review for the purpose of easing the burden of filling out schedules and of bringing the definitions in line with the information that is readily available from accounting records. Thus, the Census of Industry questions have been changed to a "shipment basis" from the previous "production basis", in recognition of the fact that, in contrast with figures on the value of commodities shipped, data on the value of commodities produced are frequently not the end result of regular accounts but must be especially calculated. Again, the so-called short form has been introduced for firms with an annual output of less than $50,000. As, in general, these firms account for a very small proportion of output their burden of response could be eased without significant loss in accuracy. Much has been done, too, to strengthen contacts with suppliers of the statistics because it is, of course, necessary for the DBS to understand the nature of the records kept by firms in order to effect improvements in the reporting of figures.

Cooperation of Business Public

In the last analysis, the service provided by DBS to the public is limited by the public's response to the Bureau's request for basic information. The DBS simply processes the information that the public provides and passes it back in aggregate and analytical form. Thus the production of accurate and prompt statistics is ultimately dependent upon the willing cooperation and goodwill of those who supply the basic data. Such willing cooperation and goodwill stems, in part, from a feeling on the part of those who are faced with the task of filling out questionnaires that the agency requesting the information does all it can to eliminate unnecessary work and ease the burden. In part, it stems from a conviction that the information requested is used for the purpose of producing useful information.

Where a firm makes direct use of the information it helps produce, it is not difficult to demonstrate that the information is useful, although collection problems have arisen even in such cases because the accounting department did not realize that the statistics were being used by its own firm. Where the information is not used directly by the firm, it may be more difficult to establish its importance. Yet direct use of the information by the respondent is not an adequate criterion as to whether or not the resultant statistics are useful to that respondent.

Firms frequently use information which was derived from surveys in which they were not themselves required to participate; for example, data dealing with the position and activities of their customers or suppliers, import statistics, or the very expensive population census figures. Clearly, if other industries and sectors of the economy contribute to statistical totals which are of use to a particular firm then it has some obligation to cooperate in the production of statistics which it may not itself use.

Benefits to the Nation

All parts of our society derive substantial benefits from the availability of good factual information. Business firms, together with all other groups in the economy, benefit from efficient government — federal, provincial, or municipal, and a modern government could no more carry on its affairs efficiently without adequate factual data than a modern business could without books. The formulation of public policy and legislation, and the administration of matters relating to resource conservation, crime suppression, public health, social security, housing, education, immigration, taxation, and similar matters of great national and regional importance, require a continuing flow of reliable and up-to-date data.

National appraisals of present and future economic prospects such as the one recently made by the Gordon Commission can be undertaken only if a large variety of good statistics is available. In the words of the preliminary report of the Commission, DBS material "not only facilitated, but indeed made possible, much of the work . . . undertaken". Above all, the maintenance of favourable economic opportunities in an economy as complex as ours entails a great deal of knowledge about economic processes and conditions, which in turn calls for general quantitative measures such as the national accounts, production and price indexes, balance of payments statements, as well as data relating to particular industries and sectors. The production of such comprehensive and varied measures necessarily assumes a very wide participation in DBS surveys by business firms and other groups in society.

Thus, the evolution of a satisfactory statistical system is a grand exercise in cooperation. Such cooperation evolves most readily when it is based on an awareness that the interests of the various parties are mutually dependent, one on the other. The growing cooperation that the DBS has been enjoying is ample evidence that this awareness has become more widespread in the business community. To heighten this awareness, particularly among those who have the difficult task of filling out DBS schedules, is a constant concern of the DBS and, indeed, is in the interests of all groups who benefit from good factual data which the complexities of our advanced industrial economy have made increasingly necessary.

The Chartered Accountant's Role as Business Adviser

WALTER L. GORDON

INCREASINGLY, over the past generation, chartered accountancy and auditing have become almost synonymous. But it was not always so. The oldest institute of chartered accountants was formed in Edinburgh in 1854, more than 100 years ago. At that time, the petitioners for a Royal Charter had this to say about their professional activities:

"That the profession of Accountants, to which the Petitioners belong, is of long standing and great respectability, and has of late years grown into very considerable importance: That the business of Accountant, as practised in Edinburgh, is varied and extensive, embracing all matters of account, and requiring for its proper execution, not merely thorough knowledge of those departments of business which fall within the province of the Actuary, but an intimate acquaintance with the general principles of law, particularly of the law of Scotland; and more especially with those branches of it which have relation to the law of merchant, to insolvency and bankruptcy, and to all rights connected with property: . . . That Accountants are also largely employed in Judicial Remits, in cases which are peculiar to the practice of Scotland, as, for instance, in Rankings and Sales, in processes of Count and Reckoning, Multiplepoinding, and others of a similar description: That they are also most commonly selected to be "Trustees on Sequestrated Estates, and under Voluntary Trusts, and in these capacities they have duties to perform, not only of the highest responsibility, and involving large pecuniary interests, but which require, in those who undertake them, great experience in business, very considerable knowledge of law, and other qualifications which can only be attained by liberal education: . . ."

It is evident that even in those days the Scots, though modest folk, were prepared to turn their hands to almost anything that came along, if there was a shilling in it. Certainly they were prepared to diversify their practices and not averse apparently to doing a little legal work on the side. But the remarkable point about the petition is that the petitioners did not seem to think it important to mention that they also did some auditing. In fact, only over the intervening years

Based on an address entitled "Challenge of Diversification" delivered at the annual conference of the Canadian Institute of Chartered Accountants, Saskatoon, Aug. 19, 1957.

has our profession made this the principal part of its business. Many of the older firms of chartered accountants in Canada built their practices initially as trustees and receivers (perhaps some of them may also have done a little multiplepoinding); only later did auditing become the backbone.

Diversification of Practice

This short detour into the history of the profession will bring to mind that the practices conducted by professional accountants in the past have been widely diversified and highly practical. It is to be hoped this will always be the case. While today we may train our students primarily as auditors and most of us spend the greater part of our time on auditing and reporting on financial statements, this does not mean that a chartered accountant in practice should now be thought impure or lacking in respectability if he ventures into other fields.

For instance, if he is as properly qualified as he should be, the practising chartered accountant will be able to advise his clients on the principles of accounting to be followed in the preparation of financial statements and, at least in a general way, on costing principles and procedures and on the most appropriate kinds of periodic statements to be prepared for control purposes including budgeting procedures, etc. These are all part of his stock in trade. Members of the public are entitled to assume that practising members of the profession are proficient in such matters just as practising members of the medical profession are expected to know what to do for a patient who has a fever or a boil on his neck.

In varying degrees most practising members of the profession probably consider themselves competent to give advice about their clients' business and financial affairs. The value of such advice will, of course, depend upon the sagacity, imagination and the experience of the practitioner. But all practising members of the profession expect their clients to consult them from time to time about their problems and welcome the opportunities to make helpful and constructive suggestions. In such intimate and personal relationships with their clients professional men find their greatest satisfaction.

It may be noted in passing that the extent to which clients rely upon the advice and help of their auditors will depend not only upon the ability and judgment of the auditor but also in some degree upon the size of the client's business. Most practising chartered accountants have had a much wider experience of business than their smaller clients and their advice can be of great help to them. On the other hand, the staff of larger client-companies will include people who have not only the same broad general experience as their external auditor, but in addition the specialized experience which comes from detailed study of particular phases of the client's operations. Larger clients, therefore, if they ask advice from chartered accountants or other professional consultants, will seek a much wider and deeper knowledge of the intricacies of business management than is likely to be possessed by the ordinary practitioner. In many cases such comprehensive knowledge and experience can only be acquired by a team of specialists acting together and no longer by a single individual.

Another aspect of practice, common to chartered accountants, is the field

of taxation. All practising chartered accountants must have a working knowledge of the tax laws and are thus often able to make notable contributions to their clients' financial well being. But the field, which includes among other things the whole area of estate planning, is complicated and technical, and no longer can a member of the profession hope to be an expert in it unless he is willing to become a specialist. Such specialization is a form of diversification, in a sense, but one with which all practising accountants must be reasonably familiar. This is like saying that all members of the medical profession should know something about psychiatry. At the same time they should recognize that they are not all experts in the technique of the couch and they should be prepared to call in specialists before, not after, their patients begin murdering their spouses.

Specialization of Practice

When we start considering diversification, specialization begins to creep in. Even within auditing and reporting upon financial statements, some specialization can be detected. We should not be surprised at this; it is merely an indication of the maturing of our profession. In the old days when there was only a limited amount to know in order to perform the audit of any business, there was little need for specialists. As business has become more complex, accounting theories more diverse and auditing procedures more elaborate, we no longer assume that every student who passes his final examinations is necessarily able to do as good a job as every other chartered accountant, no matter how experienced; or that he is fully qualified to be appointed auditor of a chartered bank or some such other large and complex institution. Some firms, including many of the smaller and medium size firms, have become specialized in brokerage accounting, grain accounting, audits of municipalities, and so on. Other firms have added to their organization specialists in different fields so that they are in a position to cope more effectively with the problems of their clients. This is particularly true in the case of the larger firms with offices across the country.

One form of diversification which would seem a logical extension of a chartered accountant's training is conspicuous by its absence in this country. Relatively few practising chartered accountants in Canada serve on boards of directors, administer investment companies and syndicates or participate in business ventures of various kinds. In the United Kingdom it is common practice for members of the profession to do so, and this tends to broaden their experience and interests and thus to make their advice more valuable. In Canada such activities are largely restricted to members of the smaller firms. Members of the larger firms have found it increasingly difficult to do these things, partly because of the conflicts of interest which may arise in a country with fewer but relatively larger companies and financial institutions and partly because of the influence of the Securities and Exchange Commission and of the profession in the United States. Many members of our profession who would like to diversify their activities by taking a more active part in business or finance, particularly at the policy level, are forced to give up practising. There is no immediate cure for this

situation but it is a pity nonetheless.

Fortunately, chartered accountants are not prevented from making contributions to the wide field of public activities. Members of professions, ours included, are a privileged minority of the population and have a special responsibility, whether in practice, industry or government service, to accept a full share of the jobs that need to be done in our communities or at provincial or national levels. We should never become so busy and preoccupied with our own affairs that we fail to meet our obligations in the public sphere. This is a form of diversification, if you will, in which all of us can be engaged.

Management Consulting

Finally, there is that broad field of varied activities which is covered by the management services departments of some of the larger accounting firms in Canada and the United States and by separate firms of management consultants.

Management consulting is, of course, an all-embracing term. Many people hold themselves out as management consultants, and while some do conscientious and worthwhile work, others, unfortunately, do not. Part of the difficulty in finding the appropriate relationship of chartered accountancy to management consulting arises from contacts which our members have had with less able and less responsible practitioners in the latter field. Another source of difficulty may be the lack of understanding about what management consulting services are and just what management consultants do.

Three Classes of Service

The best way of describing the kinds of services provided by management consulting firms is to divide them very roughly and arbitrarily into three classes. The dividing lines are not distinct and there may be differences of opinion as to whether any particular service should more properly be grouped in one category rather than another. However, the classification will be perhaps helpful for illustrative purposes.

First of all, there are certain services which most, or a goodly number of, practising chartered accountants feel they should know something about and be reasonably proficient in. Examples are the installation of detail accounting and cost systems designed primarily to assist management in controlling the operations of their respective companies or institutions; development of flexible budgets and other systems to assist management in controlling labour costs, material costs, selling and administrative expenses, office systems and procedures designed to eliminate unnecessary paper work and to reduce costs; and advice on the advantages of machine accounting.

It would certainly not be correct to suggest that every C.A. in Canada is competent to instal a standard cost system, develop a flexible budget for a large or medium size company, or be expert in all the subjects grouped in this first class. We would not expect all medical doctors to excel in the treatment of heart disease or cancer, although we are entitled to assume they have a nodding acquaintanceship with such fateful scourges. Similarly, no one would expect all lawyers to be experts in criminal, corporation or divorce law. And unlike the doctors and lawyers, the question is further complicated for chartered accountants by the fact that there are

many non-C.A.'s who are experts in the subjects under discussion, e.g. in the installation of standard cost systems. This fact should not be forgotten even though the training which a chartered accountant receives may be deemed to give him an advantage over others. Anyone who wishes to be proficient in these matters must be prepared not only to go through the initial period of training but, in addition, to spend the necessary time to keep up to date with ever-changing ideas, techniques and improvements. Poor quality service in these fields can easily damage the whole reputation of the practitioner.

The second class of services provided by management consultants are those which people with a wide variety of training skills and background can become competent to offer. Some chartered accountants have learned to provide them but they have no inherent advantages over others who have different backgrounds of training and experience. Examples of these services are organization surveys, including the development of detail charts and manuals setting out lines of authority, definitions of functions and limits of responsibility; systems for planning scheduling and controlling production; inventory controls; advice on the use of electronic computers to perform a multitude of clerical operations mechanically; integrated data processing, i.e. recording of data at the point of origin in such a way that all subsequent paper-work operations can be handled automatically without repeated copying; and "operations research", the technique for resolving problems involving many variables.

The third category of services offered by management consultants includes those in which chartered accountants, by and large, have little interest or competence, although an individual chartered accountant could become proficient in them if he wished to do so, just as might become a teacher, minister or stockbroker. Examples are sales forecasting; market research; product diversification; sales planning; sales administration, including salesmen's compensation plans; surveys of manufacturing operations, including the assessment of machinery and equipment and of labour effectiveness; time and motion study and the new techniques of work measurement and the establishment of work standards without the use of a stop watch; the installation of incentive plans; plant layout and materials handling; supervisory training; job evaluation; personnel selection, classification, training and development; and executive placement and procurement.

Management Consulting Today

The point is that management consulting firms and the management services divisions of the larger accounting firms are equipped to offer a very wide range of services. Some of these services, i.e. those in the first class, can also be performed by some, if not perhaps by most, practising chartered accountants. But there is a large class or group of services which the great majority of chartered accountants are not equipped to perform and there is another wide field or category of services in which chartered accountants, with perhaps a very few exceptions, have little or no interest. It is to be hoped the day will come when more and more practising chartered accountants will be fully competent and actively engaged in providing the kind of services listed under class one, that a fair

number of chartered accountants will become informed about and proficient in the kind of services listed in class two, and that at least a few more firms will develop their organizations to the point where they can offer all or most of the services listed under all three classes.

Whether this is done through a separate division of the firm or in some kind of association with a separate firm of management consultants is not, in my opinion, of importance as long as the business public receives the best possible service from competent and experienced people. I would urge all practising chartered accountants to take an interest in the kind of work under discussion. It is difficult, it requires specialized training and the exercise of judgment, it is not nearly as profitable as people think (it is usually highly competitive and there is not the continuity that goes with an auditing practice), but it is fascinating and constructive.

Experience of U.S. Firms

In the United States, for some years, this whole field was largely dominated by separate management consulting firms, some of which incidentally were established in the early days by certified public accountants. The business of management consulting (it is not yet and perhaps never will be a separately acknowledged profession) had a bad name for a long time due to the unprincipled and unethical pursuits of some of the more flamboyant practitioners. And many people seemed uncertain about the continuing long-term demand for the services in question. But after a period of doubt, uncertainty and suspicion, the business public and the accounting profession in the United States began to realize that the better firms of management consultants, in particular those who have agreed to abide by the strict code of ethics laid down for members of the Association of Consulting Management Engineers, Inc., were doing excellent work and that there would be a continuing need for their services.

Many of the larger and medium size U.S. accounting firms are now competing with the management consultants and I, for one, think this is all to the good. The accounting firms have, of course, a ready market available to them for such specialized services as they are equipped to perform, and the larger accounting firms are getting a great deal of business as a result. They may run into difficulties in certain specialized fields, however, where the work must be supervised by top flight experienced people who are not necessarily or even usually certified public accountants. If they are not qualified as public accountants, such people are not of course eligible to become partners in C.P.A. firms and so may become dissatisfied and difficult to hold.

Over the years the accounting firms in the United States will probably make gains in what they call "management services", particularly in the fields of activity listed in the first class. However, the better firms of management consultants can be expected to grow and prosper also. These may find it easier than the C.P.A.'s to provide all of the classes of services, and such comprehensive coverage will continue to be thought important by prospective clients both in industry and government.

Prospects for Canadian Firms

Perhaps it is too soon for any of us to foretell what the best form of development will be in Canada.

Conditions are different here, and there is no reason why we should copy automatically what our American friends are doing. But whatever pattern may emerge, many more members of our profession should get into management consulting work either as an adjunct to their present practices or in association with separate firms of management consultants. At the present time a respectable number of practising chartered accountants engage in the first class of services mentioned, several of the larger national firms have formed management services departments along roughly the same lines as those developed by the larger firms in the United States, and two of the larger Canadian firms are affiliated with separate management consulting firms.

My own experience has been that a group of experts in a variety of different skills and subjects can best be organized and directed through a separate firm in which they will all have equal opportunities for advancement. But the best form of organization is not what I wish to press for. What is of prime importance is that there should be an increasing number of people who are competent to serve business and all levels of government in Canada in the various fields we have been discussing. (And incidentally there is no reason why Canadian firms or Canadian individuals cannot be developed to do these things just as competently and expertly as anyone.) We may hope that increasing numbers of our profession will become proficient in these fields where there is a great opportunity for us. But our main objective always should be to see that the public is well and faithfully served. It would be quite wrong to adopt a restrictive, narrow, dog-in-the-manger attitude in a short sighted attempt to further our own interests.

Naturally, we should expect our members to engage in diversified or specialized activities in a dignified and ethical manner which will bring honour to the profession as well as to themselves. They should place the public interest before their own and should not use their position in a specialized or diversified activity to promote their interests in the field of accounting and auditing at the expense of fellow members of the profession.

These principles are easy to enunciate in general terms but difficult to delineate in a narrow set of rules and regulations. Those elected to serve on the councils of our various Institutes in recent years have shown wise judgment in not laying down rigid restrictions designed to prevent practising chartered accountants from entering the management consulting field, at least until the future pattern can be seen with greater clarity. At the same time there is a clear obligation on those who engage in such work to conduct themselves in a manner which will not bring discredit to the profession and which will not disturb those members of the profession who have not diversified in this fashion.

Whether we like it or not, the accounting profession has been diversifying its activities for a long time and will continue to do so in the years ahead. Management consulting is a field which offers great possibilities provided that we make ourselves competent to do the work as well or even better than anyone else. Just saying that we are management consultants will of course not be enough. That has been tried by some, though not by

members of our profession, and is why jokes are still being made about them. Someone asked me the other day if I had seen an advertisement in the Toronto *Globe & Mail* which read:

> PARTNER REQUIRED – Must have $20,000 to invest in management consulting venture; high salary plus exceptional return on investment. A lifetime opportunity. *No experience required.*

I looked up the advertisement – it seemed to be an opportunity which should not be missed. But I found that where my friend had referred to a "management consulting venture" the advertisement in fact read "public relations venture" – a very different kettle of fish. I am afraid anyone would make a grave mistake nowadays if he believed that no experience is required before setting up as a management consultant.

Fears of the Small Practitioner

Does this mean that the day of the small practitioner is over? Of course not. For even the small practitioner can specialize in one or two or more fields, and he should feel perfectly free to call in other specialists to help him when he needs assistance. By doing so he can have the best of both possible worlds and know that his client is getting the best of service. The medical profession has been following such a course for years and the same approach offers a great opportunity for ours. Someone has suggested that the practice of referring work to specialists is not more common in our profession in Canada because of fear that the specialist might use his position to supplant his fellow member of the profession in the affections of the latter's client and end up as auditor of the client company. This would be carrying diversification into the field of highway robbery. Such action on the part of a chartered accountant would be unfair, reprehensible and unprofessional, and should bring immediate disciplinary action by the Institute concerned. If the by-laws and our codes of ethics do not provide for this they should forthwith be amended. The American Institute of Certified Public Accountants is considering such amendments to its code of ethics. In the meantime, if there is any substance to these fears, at least the larger firms in Canada should state publicly that they will not accept audit engagements which might be offered them as a consequence of being called in by another member of the profession on taxation or management consulting work. Some might feel that such a statement should be quite unnecessary. Apart from this I feel confident there would be no hesitation in giving an assurance categorically.

Some people are forecasting a tremendous economic development in Canada over the next quarter century. The transition from an agricultural rural to an industrial urban economy will be completed. Great expansion will take place in the resource industries particularly in oil and gas, the generation of electric power and in mining, and there will be a great expansion also in secondary manufacturing and in the service industries. All this will call for more people with specialized training, more people with diversified experience and more people who have learned to think clearly, objectively and in broad terms. We, in this profession, are faced with a great challenge and tremendous opportunities. Let us be sure to make the most of them.

The Modern Approach to Auditing - I

HOWARD I. ROSS

Anyone who judged chartered accountants by the slogans we use as as themes for our annual conferences would conclude that we are men of the broadest possible vision: "Broadening Horizons", "The Chartered Accountant in Canada's Development" and "The Challenge of Diversification". All these imply that the old picture of the chartered accountant as a gaunt and desiccated man, wearing a green eye shade as he hunches over the minutia of debit and credit, is being replaced by a new picture of an erect figure standing four-square in the open air, his eyes shaded not by an outmoded celluloid contraption but with his own broad palm, as he surveys distant visions in the wonderful world of modern business.

This picture is all very well and certainly the profession has never had broader prospects to survey. More and more opportunities are opening up for service in diversified fields. Nevertheless it is good that we still have sessions in which we remind ourselves of the importance of auditing, which remains one of our basic functions.

Auditing is a subject which is susceptible of clear definition. We do not have the sort of problem presented to practitioners of other modern arts (such as "Operations Research" or "Rock 'n Roll" or things of that sort) which are generally conceded to be indefinable. It is therefore not necessary to pretend that there is something about our craft which is terrifically important but which cannot, unfortunately, be explained in terms comprehensible to uninitiated persons.

Auditing is quite simply the process of arriving at a competent, informed and independent opinion on a set of financial statements. To be a competent opinion, it must be given by someone who is properly qualified by training and experience. To be an informed opinion, it must be reached only after an adequate examination of the relevant facts. To be an independent opinion, it must not be given by the person responsible for producing the statements or by anyone under such person's direction or supervision. In the typical case, the auditor's opinion is an independent verdict on the financial reports of management.

A paper presented at the C.I.C.A. annual conference, Saskatoon, Aug. 20, 1957.

While auditing is not very difficult to define, it is surprising how loosely we ourselves use the term — hardly bothering to distinguish it from accounting, which is quite another matter. I object to our casual use of the term, and suggest that it is essential to good auditing to maintain a clear distinction between it and the related fields in which chartered accountants practise their profession.

Those who intend to take up the "Challenge of Diversification" will find themselves facing an infinite variety of work through which they may serve their clients. Tax or system work are examples of services which, while quite distinct from auditing, provide natural opportunities for the auditor. But however varied and important these other services are, auditing is essentially different from any of them. Like other services which a chartered accountant may perform, auditing does require skill in accounting and experience in business, but in contrast to other services, it requires a very special sort of independence. These other services must be done on a strict professional footing and, in a sense, all demand independent judgment, but not the special sort of independence that the auditor must have. We might almost say that when acting as an auditor, the chartered accountant is in the role of a judge, while beyond the audit field, he is more like a doctor or lawyer. An auditor is required to take a completely detached view of things but, so far as is known, it has never been suggested that a doctor must be completely indifferent as to whether his patient recovers or not, or that a lawyer should be disqualified if he becomes interested in the verdict to be handed down in a case he has pleaded.

Proper Financial Statements

It is the auditor's duty to decide whether a set of statements presents a fair picture. At the risk of being tedious, I would like now to examine the basic requirements in the production of proper statements — because you could define the auditor's whole job as an examination to satisfy himself that such requirements have been met.

The requirements for good statements are of two sorts. In the first place (chronologically but not always in importance) there must be a reasonably efficient procedure for recording financial transactions, so that the basic records from which the statements are prepared contain a minimum of unintentional errors or of deliberate fraudulent distortions. In the second place, there is the interpretive process in preparing the statements, which requires skill, judgment and honesty at each stage of compilation, so that appropriate and consistent accounting principles are used and the enumerable problems of evaluation are decided with good judgment. Before giving his opinion on a set of statements, the auditor must pass on both these aspects.

It is probably true to say that in talking of auditing we have usually tended to over-emphasize the importance of the procedures designed to satisfy the auditor on the recording of transactions and have correspondingly under-emphasized the auditor's interpretive functions. I like Professor Kenneth Byrd's definition of teaching auditing as teaching the use of good judgment.

Independence

No matter how skilful or well-trained a person may be and no

matter how complete an examination he may have made, his opinion on a set of statements is not an auditor's opinion if he is under the direction or supervision of the person responsible for issuing the statements.

This was emphasized many years ago when the principle was established that a director of a company could not act as auditor. When this subject was under discussion, some strong arguments were put forward in favour of allowing the auditor of a company to act as director. These arguments might be summed up (if one may be flippant on such a subject) by saying that to allow the auditor to be a director would provide the possibility that at least one of the Board would know what was going on. However, in spite of the real advantages which the combined positions might have, there would be few people today who would challenge the opinion which prevailed and which requires a strict separation of the two functions.

Fraud Detection

It would come as a surprise to some people to hear auditing defined as the development of an opinion on a set of statements. No doubt the auditor is often thought of as a sort of financial flat-foot who has somehow failed to pick up the glamour which attaches quite naturally to detective work in the criminal field. But the right and current trend is to emphasize not fraud detection but the giving of an independent opinion. Letters to the editor of *The Canadian Chartered Accountant* are rarer than they should be, but a reference to fraud detection in a recent editorial certainly drew quick response from several prominent members, who pointed out the subsidiary importance of this aspect in auditing, a point on which we are understandably sensitive.

We simply must not, however, dismiss the question of fraud detection casually. Granted that the auditor's main function is to provide an independent professional opinion, the detection of fraud in the accounts is an important job in any audit, even though not the principal object. This is demonstrated by many features in modern auditing: the surprise element that we are careful to protect in performing many procedures; the cross-checking of one result with another; our emphasis on division of responsibility and internal control in general; direct communication with debtors and depositaries, and so on. All of these emphasize the auditor's concern with fraud detection. Certainly an auditor would hope to discover in the course of his examination any serious, bare-faced fraud.

Of course, it might be more pleasant for the auditor if he could dismiss the nasty possibility of fraud entirely from his mind, but it is doubtful anyone would go that far. Nor is it good enough to say that an auditor should concentrate entirely on the granting of his opinion and take note of fraud only when he stumbles over it in pursuit of his main goal.

If we can agree that fraud detection is an important object of auditing but not the principal object, we are still left with the difficult problem of how far the auditor should go in probing for fraudulent manipulations. This question is all the more difficult and requires all the better judgment because it is a subsidiary, though essential, concern of the auditor. It would no doubt be easier to draw up an audit program against

fraud if this was the auditor's sole or even principal objective.

I remember once staying as a guest in a large English country house. At night my host would slide a heavy wrought-iron bar in place to secure the front door, which was of three-inch oak. It would have taken a battering ram to break into the house through the front door. On the other hand, a few feet removed was a row of French windows which any prowler could have opened with a reasonably strong pen-knife. It was, my host explained, his determination that if a burglar entered his house at night it would not be through the front door. This rather British incident illustrates at least the minimum viewpoint of the auditor in respect to fraud. He must be sure not to overlook fraud through the front door.

It is in this light that much of the auditor's work must be judged. For example, it is easy to imagine the difficulties of an auditor setting out to examine an inventory of chemicals. It is unlikely that he will be able to distinguish between, say, an enormously valuable white powder and common table-salt. (Except perhaps by taste, and there are probably auditors who would hesitate to go around tasting all white powders in a chemical inventory, on the odd chance of locating the substitution of common table-salt for a more valuable material. I personally would not like to see the day when the auditor has to report, "We have tasted the inventory and in our opinion . . .").

However the inescapable difficulties of inventory inspection and classification could not justify an auditor in turning his back on this important asset. As everyone knows we have, in fact, developed procedures which enable us to make useful inventory tests, even though they should not be expected to disclose every variety of fraud.

The Modern Approach

As we are discussing modern trends in auditing, we might now consider the question of "how recent is modern?" From this point of view, the thing that immediately strikes one is how recent our whole professional development is. The Scottish Institute was founded just over 100 years ago, while our Quebec Institute, which missed by a matter of a few months being the second oldest accounting society in the world, celebrated its 75th anniversary just last year. It is hardly necessary to speak of "modern" auditing, as that is about the only kind there is.

In this respect we contrast sharply with "other professions in which men engage – the army, the navy, the church and the stage"; not to mention medicine or the bar. All these have much longer histories than we but this need not disturb us. The worth of a profession is not to be judged by age, a fact which would seem to be demonstrated by the very low prestige attached to membership in that profession which, by general consent, is conceded to be the oldest profession in the world.

While we should not disparage the pioneer work of those 19th century auditors who laid the foundations of our profession, it is almost true to say that the whole development of auditing has been within the past 50 years. (For one thing, consider the size of the profession. Our Institute had 64 members in 1907 and now has 7,500.)

This rapid and recent development is not very surprising as it parallels the complete revolution in our economy which has taken place during this short period. The extent of the change in the accounting and auditing field is sometimes not appreciated because there is a deceptive similarity, in a superficial way, between the financial statements of 50 years ago and those of today. If we compare an old set of statements with a modern one, a general similarity may often be noticed. The magnificent equality of debit and credit is, of course, very old, and examples can be found of balance sheets produced around 1900 in a form quite similar to the best of modern statements. However, we all know how misleading this similarity is, and how much refinement and change has gone into the whole process of statement production. Perhaps even more strikingly, auditing methods have changed, as they have had to change to keep up with the growing size and complexity of modern business.

Recent Complications

In the first place, let us consider for a moment the increasing complexity of business morality. It was only about 50 years ago that we had a sort of shopkeeper's economy. Business enterprises were small-scale and, except in a few instances, were personally supervised by the owners. Anyone who wanted to be honest must have had little difficulty in locating the path of rectitude. To be a good man was largely a matter of giving honest weight and measure. Financial statements were simple, and almost wholly for credit purposes. A good balance sheet was one which presented what came to be described as a "conservative" picture, and a good operating statement was one which reconciled the opening and closing balances of surplus. (It is perhaps mildly ironical that just as the word "conservative" is losing some of its former respect in accounting, it is taking on new life in other spheres.)

This almost Arcadian simplicity of life is a far cry from today. Any number of factors have contributed complications. A few of them are the vastly increased size of commercial enterprise, separation of ownership and management, demands of investors (both buyers and sellers), fearful exigencies of tax departments, emphasis on accurate income determination and the general overwhelming speed-up in the tempo of life.

The cumulative effect of all these trends might be illustrated by our developing concern about events after the balance sheet date. Clearly, a violent change in a company's position subsequent to the balance sheet date should not be passed over in silence in a statement issued after the event. But procedures for discovering such happenings are particularly difficult to devise. After all, the auditor must stop somewhere and the company's staff is often engrossed in producing the annual statements, thus letting the current year's accounting lag. It cannot be suggested that we know the answer to this one yet, but it does afford an example of developing complexities.

Every one of these factors puts a new value on financial statements and increases the problems of judgment encountered in preparing them. We face today, in issuing a statement, not only what is, after all, the fairly straight-forward question of

whether we intend to be honest or not, but the frequently more difficult problem of what sort of presentation is in fact most honest and least likely to be misleading. All of this has enhanced the difficulty of the auditor's job and, correspondingly, its importance.

One might perhaps be justified in venturing the generalization that within the past 50 years the nature of auditing has changed from what was essentially a meticulous routine checking to a highly skilled appraisal of business transactions under the complicating factors to which we have just alluded. Certainly the interpretive part of our work has come more to the fore. It is incomparably difficult to select the interpretation which will give a fair and consistent picture than merely to select some figure which will not overstate net assets.

Observe one further point. All these trends in modern business have a double-barrelled effect on auditing. Not only does the auditor's interpretive work become of increasing importance, but in his examination of the system of recording, he finds it more and more difficult to derive satisfaction from routine or mechanical tests. Even in his appraisal of the efficiency of the recording function, growing volume and complexity force the auditor more to analytical appraisals and less to routine procedures.

In every sense, the trend is developing away from hum-drum repetitions of the processes through which the accountant has gone and more towards the sort of analysis work that requires skill and training. Originally it was all very well for the auditor to follow the accountant around repeating each process the accountant had gone through before him. Now the accountant has become mechanized and "punch-cardified" and is well on the way to becoming "electronified".

Scope of Audit

The trends towards complexity and greater volume of transactions have taken us far away from the days when the auditor had the simple task of checking everything. This has produced the new problem of deciding on the scope of the audit examination.

It should be remembered that this is the auditor's problem and no one else's. The special degree of independence which a chartered accountant must have when doing an audit (in distinction to performing other services for a client) means that he must be allowed to decide on the extent of examination necessary in order to reach a professional opinion on the statements. Clearly he would not have the proper independence if someone told him how much of an examination to make.

Perhaps this point is important enough for an illustrative example. Let us contrast the chartered accountant's obligations in inventory examination when acting as an auditor, with his obligations when acting in another capacity. It has been pretty well established that when acting as an auditor he should be present at inventory taking and should carry out such tests as he thinks are appropriate. It is not up to anyone else to tell him what to do. As with the rest of his program, this is a matter for the auditor to decide in his best judgment. However, if a client is investigating the purchase of another business, and

wants his own auditor to assist him in appraising this other business, it is quite proper for the client to ask his auditor to make any kind of tests which the client wants. He may want the inventory examined, but it is up to him to decide what work he wants done. The chartered accountant in such cases is in an entirely different position from the one he assumes when he accepts an appointment as a shareholder's auditor.

This point has been laboured because a vital corollary clearly emerges from it. If the auditor must be allowed to do any work he considers necessary before giving an opinion on a set of statements, it follows that he must assume the responsibility of doing his examination as efficiently as possible. It would be quite intolerable if an auditor insisted on his right to do any tests he considered necessary, and then proceeded to waste time (and therefore his client's money) in doing work which was not reasonably required in forming an opinion.

The question of what work should, or should not, be done is a matter of judgment at every step in the audit process, and it is difficult to draw up general rules. The onus is on the auditor to do his work as speedily as possible, but this is not an obligation which he should attempt to avoid. He must decide on the scope of his audit.

(*The concluding portion of this paper will be published in the November issue.*)

COFFEE BREAKS JUSTIFIED

When Archbishop Laud, as it is alleged, introduced coffee into this country through his Cretan protege, Nathaniel Canopis, he could hardly have foreseen how stimulating the black brew would prove to trade and commerce. Many a great enterprise owes its origin to the coffee-houses where, in the 17th century, men of affairs met to exchange gossip and the latest commercial and political intelligence. The Stock Exchange is a direct descendant of "Jonathan's", the shipping exchange of "The Baltic Coffee House", and Lloyd's of London was born in the coffee-house of Edward Lloyd, which was in existence in 1688, eight years before the creation of the Bank of England.

– *The Accountant*, September 7, 1957

Preparing an Accounting Manual for a Company

H. O. McNUTT

THE OXFORD dictionary defines a manual as "a small book for handy use". In the mediaeval church it meant a book containing the forms to be used in administration of the sacraments. The word comes from the Latin *manus* meaning "hand" and was used as early as 1533 to mean a "handbook". It continues to be accepted by students of the arts and professions, and an accountants' handbook is, today, one of his necessary tools.

A book of instructions, often referred to as a manual of instructions, is included with the purchase of many household appliances or hobby equipment to help the user to operate and care for the device properly and obtain maximum efficiency and pleasure from it. For instance, a fine camera will produce good pictures if the user follows the instructions in the carefully prepared operating manual.

A business too will produce better results if carefully planned procedures are followed by those responsible for its operation. Management has learned to rely more and more on data and reports produced by the accounting department when making important decisions. The accounting personnel, however, must be well qualified and properly guided to accomplish the objectives of the accounting function.

The use of a well prepared instructional manual can contribute much toward the successful performance of the accounting department. This fact is recognized generally by accounting management, and many fine manuals are in use today. Admittedly, most of these are in large companies where the accounting effort is sufficient to support a full-time systems and methods or manual preparation group. Managers of small businesses also may find considerable advantage in setting up an accounting manual as it affects their different operations, and the cost of preparation will be justified in view of the potential improvement in controls and operating reports. The manual need not be elaborate or voluminous but should contain sufficient detail to set out adequately and simply the purposes, objectives and scope of the accounting function, with clear instructions for carrying out each step of each activity.

Purpose and Objectives

The purpose and objectives of an accounting manual will vary to some

degree with different companies. Primarily, the manual should:

1. *Explain the purpose of the accounting function and its relationship to the overall business.* This introductory section should outline briefly the philosophy of accounting and establish the position of the accounting department in relation to other phases of the business. Background information of this nature is extremely important but, unfortunately, is often omitted.
2. *Set out the objectives of the accounting department.* These can be grouped into two categories, both usually applicable to some degree to each specific function. They are –
   (a) Performance of the stewardship or control and other commercial necessities involved in the operation of the business, such as payroll, material handling, accounts payable, etc.
   (b) Providing information in report form to all levels of management (and to regulatory bodies) for use in controlling the business. Management decisions depend to a considerable degree on the timely regular flow of accurate data presented by the accounting department in concise, simple, easily understood reports. Detailed instructions for accumulating, digesting and presenting these data should be one purpose of an accounting manual.
3. *Include performance instructions in sufficient detail to enable a competent staff to carry on the function and achieve the stated objectives.* This is where the experience of those preparing the manual counts most. Instructions for every function should be included, but the tendency for too much detail must be carefully checked. One must assume that performance will be in accord with manual instructions so the model must be representative of the objectives. In addition to specific operational instructions, certain other types of related details should be included, for instance:
   (a) The manual must first contain a catalogue or chart of accounts to be used in the conduct of the business. Some brief explanations covering the intended use and content of the accounts may be desirable.
   (b) If the business has more than one accounting office a procedural framework should be included so that sufficient uniformity will exist to allow ready consolidation of final results.
   (c) The manual should also instruct the user in the orderly accumulation of data so that future use of the accounting records will involve a minimum of clerical effort.

Other Functions of a Manual

These three basic objectives pertain chiefly to the actual accounting function. Management will also find the accounting manual a means of communicating company policy and the objectives of all departments in the company as these affect each manager. Interpretation of policy, methods and procedures can be made

available to various levels of management through the manual. Changes in policy or improvements in accounting techniques can be communicated throughout the company by manual change sheets. This is one way accounting can be made a more effective tool for management.

Training new employees in the accounting department and preparing regular employees for new jobs or advancement are simplified if a functional procedural manual is available. It provides the learner with the complete story of an accounting function and enables him to fully understand his part of it. A knowledge of the objectives of the function will usually permit the employee to do a better job.

The manual will prove to be helpful in the preparation of periodic profit or loss statements, and other financial statements for shareholder, company, and tax purposes. It is an excellent aid to the company in setting out its economic position for regulatory bodies. It should contain guidance in the use of the company's cost control system including the development of adequate costs to serve as guides for pricing products and in establishing cost trends to provide data necessary for long range planning, short term production and distribution patterns.

Scope of the Manual

The subject matter in the manual should be selected to suit the special needs of each business or company. Its scope and the extent of the detailed instructions will depend upon the size and number of accounting offices in the business, complexity of the accounting operations, requirements of the business and the ability of management to use the detail to advantage.

A general framework should relate all the various accounting functions of the business. Control checkpoints are necessary within this framework, but the manual should be flexible enough to allow the accountant to use his own initiative to supply the required detail.

The manual serves a variety of purposes from supplying the basic classification of accounts used in the business to the detailing of highly specialized procedures dealing with many phases of accounting. A basic manual for any business would probably include such primary functions as payroll, materials procurement and handling, accounts receivable and payable, production costing, packaging and shipping costs, and other general accounting routines. Other more specialized functions such as job or product costing, attest procedures, financial reporting, machine accounting and cost control might be included if the business so required.

The scope of the instructions should extend from the creation or receipt of basic accounting data through all phases of processing by the accounting office to the finished reporting procedure. The audit and attest procedures should be set out, by functions, in a separate volume with restricted distribution.

Large companies may find the manual extends to a number of volumes in order to describe the normal sequence of steps in each accounting function.

Preparing the Manual

Preparation of the manual should be delegated to a senior accountant or systems and methods employee

possessing an intimate knowledge of the accounting function and of company policy as it affects matters pertaining to accounting. This knowledge should be backed up by actual experience in the company. The project may involve a number of people if the company's accounting function is extensive or widespread. It may be practicable to have those accountants who will be using the manual participate in its development and preparation. This ensures ready acceptance by the staff and also brings out the valuable viewpoints of those most concerned. Those involved in the preparation of an accounting manual may find the following "rules" helpful:

1. A volume of good general overall appearance, with subjects and headings well set out, will create interest in the reader even before it is read or analyzed.
2. Size, type of binder, colour of paper, method of indexing, dividers, etc. should be selected from an utilitarian point of view. The general format of the manual should be consistent with other company communications and directives.
3. The contents should be arranged conveniently and in logical sequence from the user's viewpoint. This will permit easy review and approval by management and form a ready reference for those using the manual. A well ordered manual will be appreciated by auditors and inspectors representing regulatory bodies.
4. The descriptive material relating to each function should be carefully selected and all instructional details pertaining to each step of the function should be accurate, complete and relevant.
5. Terminology should be limited to that commonly used by accounting personnel. The use of simple words with specific meaning, signs, symbols and properly completed examples of forms, cannot be over-emphasized. Use charts, flow diagrams and illustrations wherever possible, as they are particularly helpful when a number of offices are involved. The clerk's answer to many questionable results may well be "That's what the manual says". Short sentences containing separate ideas help the user interpret instructions and make the manual easy to read.
6. New ideas or procedures should be associated with knowledge the staff already possesses. The mechanics of the presentation should be recognizable and familiar enough to be accepted by the accounting staff so as to permit concentration on the instructional content. The staff should be kept in mind constantly during preparation of the manual.

It may be desirable to include in the manual an outline of the responsibilities of the various levels of accounting personnel and to relate specific functions to these people. Certain of these responsibilities may be isolated and emphasized if this practice is adopted. It is essential to have uniform procedures and individuality of detail.

The auditing firm responsible for the shareholders' audit will appreciate the opportunity to review and comment on the manual before it is adopted for implementation. Its approval is additional assurance to the company's management that the accounting procedures are acceptable.

Implementation and Follow-up

The accounting staff will be looking forward to the release of the new accounting manual. Win them over by issuing it well in advance of the implementation date. If the manual is voluminous, time should be allowed by the company for study and discussion. Certain members of the staff will want to study it in detail on their own time.

It is important, however, that all levels of staff know the manual and its provisions. Supervisors have some responsibility for training their personnel. Issuing of the new manual is an opportune time to discuss any new procedures introduced. Staff members will attempt to relate the new instructions to their present routines and methods. Acceptance of the new approach will depend on how well the manual stimulates interest, and the degree of interest will prove that the objectives and procedures are clearly defined, necessary, desirable and attainable.

Supervisors, staff and management must be prepared for a "debugging" period, the initial test period when potential difficulties arise. This is particularly true if the new manual alters the existing procedures significantly. Senior employees may secretly or openly resent some new approach that eliminates procedures which have been in effect for some time, particularly if the old methods were suggested or developed by them.

Writing the manual is a long laborious task that will take months to complete. Its review and acquainting the accounting staff with its contents are also time consuming. Adopting the manual and implementing the new system are best accomplished by changing over on a function-by-function basis. This gives the staff and management opportunity to review the effectiveness of the new manual progressively.

Supervisors will find it necessary to be more alert and attentive than usual. Each step of the function will require examination and comparison with the manual instructions. The follow-up period should continue until the staff is familiar with all phases of the function. Comparison with the previous office schedule as to completion times, overtime worked, appearance of the completed work, simplicity of the system, effect of multiuse reports and other changes will measure the success of the project.

Management should be alert to observe the users' reactions and general acceptance of the accounting manual to be assured that the new system is being given a fair trial during the initial period.

The follow-up activity may disclose some weakness in the untried new system, or some member of the staff may work out what he considers to be a simpler handling procedure. The supervisors should be quick to investigate any suggested change and to recommend a revision if warranted, even during the test period. Alternative methods may be generated from the prescribed manual methods and these should be tested for practicability. Management should be prepared to amend the manual when improved procedures become available.

Revising the Manual

In addition to the changes in the manual brought about during the initial test period, a competent person or persons should keep the volume up to date. This will tend to avoid

authorizing changes or new procedures verbally or by correspondence. Large companies will find the task of maintaining a manual a full time one; the smaller company may find a monthly, quarterly, or even yearly revision adequate for its needs.

A revision procedure should be planned for the accounting manual. A common method is the issuing of correction or change bulletins when warranted. The bulletin may consist of a covering form letter, serially numbered, containing explanatory notes attached to revised numbered pages to be inserted in the manual.

To keep current on accounting matters, accountants, particularly those charged with the responsibility of systems and methods and manual maintenance, will find it advisable to hold memberships and participate in the activities of accounting organizations. Some time should be allotted for perusal and study of magazine articles, bulletins, organizational and accounting journals, etc.

Case History

Imperial Oil Limited is a large fully integrated oil company. Its field of activity in Canada extends from Newfoundland to Vancouver Island, and from the United States border to its northern Fort Norman crude oil producing field and refinery located within 90 miles of the Arctic Circle.

The company uses manuals extensively. Operating manuals covering the physical operations of plant and equipment are used by its operating departments. These may apply to large process units in a refinery, seismograph equipment in the producing department, or to unloading procedures pertaining to a railway tank car. They are prepared by our engineering or process operating departments and in some cases may be supplied by equipment manufacturers.

Accounting for nine refineries, eight marketing divisions, crude oil producing activities in the west and east, pipe lines, tankers, tank cars, and the thousands of marketing terminals and service stations is a big job. Accounting procedures in the operating field offices must be carefully coordinated with the comptroller's control and consolidating procedures in the Toronto executive offices to produce timely and informative reports for various levels of management. Essential data and information are prepared in accordance with departmental procedure manuals and submitted at predetermined periods. These accounting procedures and the preparation and scheduling of data between field and head offices are constantly being studied and improved.

Imperial has adopted a very complete and comprehensive general accounting manual containing general instructions for all departmental accounting functions in field and head offices, corporate division accounting and the compilation of financial statements for the company. Copies of this manual, supplied to all accounting offices, are kept up to date with bulletins complete with interpretive and supplementary directives issued by the comptroller's department. This department has responsibility for the implementation and policing of the overall accounting function and the coordination of field office accounting with the head office.

The accounting manual general instructions are detailed further in specially prepared accounting procedure manuals. These are developed

on a departmental basis and kept current by the comptroller's department with the assistance of the field operating offices. They are prepared by functions such as payroll, order and billing, plant investment, stock control, internal control and attest, materials and supplies, financial reports, etc.

The manuals are detailed enough to ensure uniformity in the accounting operations and practices, and in the accumulation and presentation of data to local and head office managements. On the other hand, they are intended only as guides and so are sufficiently broad in scope to permit local accounting office personnel to use initiative and judgment in establishing office routines. The manuals include partially completed sample forms and flowcharts to indicate the logical sequence of operations and distribution of completed forms and reports.

Procedures are first written in draft form. The draft copies are sent to the field offices concerned for review. Field office accountants study the proposed procedure from an operating and practical viewpoint and, in some instances, try out the proposal for a period of time. They submit comments and suggestions, and revisions are made to the proposed procedure. The revision is sent out repeatedly to field offices during the development stage. In this way, a workable procedure is developed jointly with the offices concerned and so is readily accepted and implemented by them. The procedure is written in simple language, with familiar symbols and examples of forms. The finished procedure is reviewed by the comptroller before it is released.

Copies of all procedure manuals are submitted to the company's internal and shareholders' auditors before release. Changes to procedural manuals are recommended by field and head office accountants, and the internal and shareholder auditors. The recommendations are developed fully by the comptroller's department. The manuals are constantly being studied, changed and updated and form an important link in Imperial's accounting chain.

In Review

The fact that the 16th century "handbook" in its revised version is still used in certain churches today may be some justification for its creation. Time has not yet placed its stamp of approval on the accounting manual but present day accountants seem to value it highly.

The practicability of what has been written in this article was proved during the Second World War. The turnover and scarcity of accounting personnel at certain strategic locations necessitated using female and junior clerks for even the more advanced accounting functions. The rapid development of detailed procedural manuals and intensive on-the-job training partially solved this personnel problem.

The increased demands on industry today for more information for control purposes and to satisfy governmental requirements, and the advanced technology of modern production and manufacturing facilities, have combined to complicate and expand our accounting systems. This complexity and the constant changing of procedures can be controlled more easily if well written accounting procedural manuals are included as part of the accounting systems.

Some Pitfalls of Tax Compliance

T. A. M. HUTCHISON

The problems involved in tax compliance apply to individuals just as much as to business enterprises but for the purpose of this paper, comments will be confined mainly to the business sphere.

A section of prime importance affecting business in the Income Tax Act is section 4 which says in effect that as a starting point the income for a taxation year from a business or property is the profit therefrom for the year. At first glance this definition of income should not present too great a problem because the businessman thinks that he knows what his profit is for the year when his financial statement has been completed and the auditor has reported on it. However, decisions by the courts and specific provisions inserted in the Act have over the years been driving profit as determined under sound business and accounting practice further and further apart from profit as determined under the taxing Acts.

For accountants to accept the proposition that sound business practice should differ from sound accounting practice would be heresy since, if an outlay can be charged to the expense of a business under sound accounting practice, it must be a proper expense to be incurred by that business.

It has already been stated that specific provisions of the Income Tax Act will always overrule sound business or accounting practice in the determination of profit. Unfortunately, the Act includes some provisions which are contrary to sound business and accounting practice, and probably the worst example in this respect is section 85B which brings into the income of a taxpayer for a taxation year every amount received in the year and every amount receivable in the year for property sold or services rendered, and then does not always grant deduction in full but only amounts computed in accordance with the provisions of the section.

This section was a direct outgrowth of the *Capital Transit* decision and others following the same general principle, which subjected to tax as income amounts received for sale of bus tickets, deposits on containers and similar items, even though the liability to supply the service still remained. Under sound business and accounting practice amounts received or receiv-

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able of this nature could not be included in income, but the lower courts held that the liability accounts for bus tickets, returnable containers and similar items were in the nature of reserves which were specifically barred under the provisions of the taxing Act. Initially the enactment of section 85B appeared to afford many taxpayers the relief needed, but unfortunately it now appears to be contributing to the threatened taxation of contractors and land developers on amounts deemed to be profits even though the project involved may be far from completion and accurate determination of profit an impossibility.

Disallowed Deductions

Some part of the blame for the decisions of the Appeal Board in these matters must rest with the accounting profession who acquiesced in the use of wording in financial statements describing as reserves what were really liabilities for goods to be supplied or services rendered. It was inevitable that under the provisions of section 12(1)(e), which disallows deduction of an amount credited to a reserve, taxpayers could expect to be challenged by the tax authorities on the so-called "reserves". It is to be regretted that the reserve cases were not carried to a higher court where the confusion might have been clarified as to the nature of the so-called "reserves", in which case it might never have been necessary to introduce a section as vicious in principle as section 85B.

When considering the inclusion of receipts as income and the deduction of expenses from income it is important to distinguish between those which result in taxation on a once and for all basis and those which are merely a matter of timing. Many of the provisions in the Income Tax Act, such as those in section 85B, which have just been mentioned, and those allowing deduction of reserves for doubtful accounts, merely involve a matter of timing in that the income will be taxed in one year or another. Similarly, disallowance for expense accruals, if the expense will be allowed when actually paid, does not result in a permanent disallowance. It is therefore particularly important to ensure that receipts which could be considered of a capital nature, and therefore not subject to tax at any time, are excluded from income and that payments are not disallowed as a deduction on the grounds that they are of a non-depreciable capital nature. It must be remembered, however, that so long as an enterprise continues in business, if it accepts the taxation of receipts in advance of being actually earned or vice versa the disallowance of accruals for expenses which have been incurred in the year's operations, then it will have made a permanent prepayment of income tax on anticipated income thus subjected to tax.

The general limitation on deduction of expenses is set out in section 12(1)(a) which prevents deduction of expenses except to the extent that the expenditure was made or incurred for the purpose of gaining or producing income from property or the business of the taxpayer. While there have been disallowances of expenses under this provision, usually they are disallowed as being of a capital nature and therefore barred by section 12(1)(b). A provision which should be considered but which does not seem to have been invoked to any great extent by the taxing authorities

is that contained in section 12(2) which prohibits the deduction of an outlay or expense except to the extent that they are reasonable in the circumstances.

The present Income Tax Act appears to contemplate that all expenditures are either of a capital nature or an expense of the year in which incurred. Section 12(1)(b) specifically bars any deduction for an outlay or a payment on account of capital except as expressly permitted under the Act which in turn means mainly under the depreciation and depletion allowance regulations issued under section 11(1)(a) and (b). While this arbitrary division may be desirable from the standpoint of administering the Act, it does create problems from the standpoint of sound business and accounting practice. All proper expenditures made by a business create something of value to the business. The expenditure may be for a sheet of paper in which case it has only monetary value. On the other hand, if the expenditure is for a building it will have value to the business extending over many years. Because the financial results of a business are determined on a periodic basis, sound business and accounting practice requires the allocation of expenditures to the periods when the value of the expenditures is consumed. However, from a taxation viewpoint, it is vital that expenditures should be charged against the year in which incurred unless they are of a nature which will entitle them to capital cost allowances under the Act or are in the nature of permanent investments such as land and investments in securities of other business enterprises as otherwise it may be impossible to obtain deduction for the expenses at any time.

Prior Practice Not a Precedent

A taxpayer's compliance may proceed on an amicable and easy basis merely by reason of the acceptance by the taxing authorities of a particular business and accounting practice which has been followed over a period of years. There is considerable danger in relying upon the acceptance of prior practice because the provisions of the Act rule and if the precise meaning of the provisions of the Act is not being applied in determining taxable income, it is not unlikely that at a later date the taxing authorities may decide on the basis of court decisions or general application to change their practice. An instance of this was the developing change of basis of taxation of contractors which has already been referred to and which followed some time after the introduction of section 85B into the Act. Another instance encountered by many business taxpayers is the changed attitude on the part of the taxing authorities in dealing with the determination of the reserve for doubtful debts. Formulas for determining the reserve on an ageing basis, which had been accepted over a period of years, have been disputed and attempts made to impose a requirement that the reserve should cover specific accounts of a doubtful nature with no allowance for the probability of loss on overdue accounts in general where loss cannot be demonstrated at the time.

Taxpayers will occasionally find that some particular condition or situation in their business causes them to be liable to income tax where in equity no liability to tax should exist. Sometimes this may arise from the lack of any special provision in

the Act to deal with the particular situation and at other times it may be caused by some specific provision of the Act. It must be recognized that it is impossible to legislate for every possible circumstance so as to avoid inequities. Nevertheless, if the inequity has an important effect on the taxpayer and if good grounds for complaint can be presented, it is worthwhile presenting a case to the Minister of Finance requesting relief by an amendment to the Income Tax Act. The case is obviously much stronger if it can be presented as affecting a group of taxpayers rather than an individual taxpayer.

Concurrence in Consistency

It is important to consider here the provisions of section 14 which call for consistency in accounting treatment once a taxpayer has adopted a method for computing income unless concurrence of the Minister is obtained to any change. Often when a question arises as to how income or expense is to be handled in the accounts, particularly in the case of new businesses, an accounting treatment is adopted which may be satisfactory at the time partly because the amounts involved are insignificant. However, the adoption of that practice may bind the company to continue the practice for taxation purposes when the amounts and circumstances are quite different. For similar reasons the basis for determining the value of inventories in a new business is important because any change from this basis will require the concurrence of the taxing authorities.

Provision is contained in section 12(3) whereby deduction can be disallowed of amounts payable to a person with whom the taxpayer was not dealing at arms length if the amount has not been paid within one year after the end of the taxation year. It not infrequently happens that in the subsidiary-parent company relationship, the subsidiary purchases merchandise and services from the parent company and does not complete payment over an extended period probably as a means of financing where there is a shortage of working capital. It is possible to effect payment, which will meet the technical requirements of the Act, by having the subsidiary pay the parent company and the parent company make an advance back to the subsidiary. While this provision might have been intended to enable the taxing authorities to disallow a deduction, it may also be used by a taxpayer for the purpose of preserving a loss carry forward, by having the taxpayer refrain from paying for purchases made from a non-arms length supplier for a period of one year after the year end, thus automatically reducing the loss carry forward by the amount of the non-arms length purchases unpaid for the one year period.

Transactions with Shareholders

The provisions dealing with appropriations of property to shareholders in section 8(1) and with artificial transactions in section 137 are frequently ignored in the course of the ordinary operations of a business enterprise. Taxpayers should give careful consideration to transactions with shareholders which might confer any kind of benefit on a shareholder to be sure that they do not inadvertently create taxable income for the shareholder involved. It is worth noting that the provisions of section 8(1) are not invoked on the winding up, discontinuance or reorganization of a company's business and that it may

therefore be advisable to take this step before granting any benefit to a shareholder. However, in the winding up of a company to avoid the provisions of section 8(1) on the appropriation of property to a shareholder, consideration must be given as well to section 17(6) which provides that the company's income can be deemed to include an increase arising from using fair market value for property appropriated and this in turn could increase the undistributed income at the time of winding up and thus increase the deemed dividend taxable in the hands of the shareholder.

Non-Arms Length Transactions

The transactions between business concerns which do not deal with each other at arms length are very frequent, particularly in large complex business enterprises. Normally too little consideration is given to the basis of value on which such transactions are consummated. Whenever transactions are undertaken between parent and subsidiary companies or companies in a group and, of course, between companies and any shareholders with whom they do not deal at arms length, careful consideration should be given to the provisions of section 17 which cover purchases and sales of merchandise and payments received and made for rentals, royalties and other kinds of services. A particularly important consideration here may be that while under section 17 one company's income can be increased by placing the non-arms length transaction on a fair market value basis, there is nothing in the Act which will automatically permit the other party to the transaction to take up the counterpart of the adjustment in its accounts. It is probably the case that in most instances the taxing authorities would permit such an adjustment but the taxpayer cannot claim it as a matter of right, and if the years involved have been finally assessed it could be difficult to obtain the proper adjustment.

Lease option and hire purchase agreements are now so commonplace that most business taxpayers would have some knowledge of the tax risk involved, namely that under section 18 the rent will be disallowed as an expense of the lessee and in its place the lessee will be allowed a capital cost allowance normally calculated on the aggregate of the rent payable over the period of the lease plus the purchase price under the option. In this connection the amount, as so calculated, will require to be allocated between land and buildings for the purpose of determining the amount on which capital cost allowances can be calculated. Since it is obviously desirable to reduce the amount of rent, which will be disallowed, the general practice is to arrange that the lessee will pay all taxes, insurance, maintenance and similar items thus reducing the required rental to the minimum.

When selling or disposing of depreciable property, it is important to consider the provisions of section 20(6)(g) under which the income tax authorities can require an allocation of the consideration received on a reasonable basis as between depreciable property and other property. This provision is directed primarily to ensuring that recapture of capital cost allowances will be made on the basis of reasonable values for the depreciable property and not on the basis of arbitrary values possibly covered by the terms of some agreement. However, the provision also

sets out that the person to whom the depreciable property was sold is deemed to have acquired the property at the same value as that attributed to the vendor. Consequently, the purchaser of fixed assets needs to be as much on the alert as the vendor and cannot depend upon claiming capital cost allowances on the amounts provided for in an agreement as the values of fixed assets unless such values will bear the test of reasonableness.

A section to which too little attention is often given is section 6(j) which requires that payments received that are dependent upon the use or production of property are to be included in taxable income even though the payments are to be applied on the sale price of the property involved. A recent decision of the Appeal Board, *No. 383* v. *M.N.R.*, appears to have given an exactly reverse treatment to a taxpayer who agreed to pay a sum per square foot of a product sold in order to acquire an exclusive right to purchase a particular product and was then disallowed the payment as a deduction on the grounds that it was made by the taxpayer in order to acquire a "right" and therefore was of a capital nature. It would seem probable that there are many contracts between business concerns calling for payments which are based on quantities or values sold and grant exclusive rights to the purchaser in a particular territory in consideration of such payment.

Charging of Repairs

Over the years the charging of repairs as an operating expense has probably given rise to as many differences of opinion between taxpayers and the taxing authorities as any other matter. Generally speaking, there is no difficulty with respect to minor repairs and maintenance charges that recur from year to year. Similarly, where a new asset is acquired involving an expenditure of more than a nominal amount the taxpayer is in no doubt that it must be regarded as a capital item. The real difficulty occurs where major repairs are affected and the question then often arises as to whether or not the expenditure is a deductible repair or an outlay of a capital nature which is non-deductible.

The recent *Thompson Construction* and *Vancouver Tugboat* decisions of the Exchequer Court have held that the replacement of engines in a power shovel or in a tugboat brought into existence a new capital asset and an advantage for the enduring benefit of the company's trade. On the basis of these decisions, taxpayers will need to give very careful consideration to the handling of major repairs, and if they are to be charged to expense, the taxpayer should be prepared to support the position that a new asset is not being brought into existence.

The tax conventions between Canada and foreign countries, in particular that between Canada and the U.S., should receive careful consideration. The provisions of Articles III and IV are of particular importance to business enterprises. It is sometimes not appreciated that these articles in effect provide that a taxpayer may claim that the net profit to be attributed to the "permanent establishment" is to be determined as if it were an independent enterprise. This principle, if followed, leads to the conclusion that transactions between the permanent establishments of an enterprise in the two countries

should be placed on the basis which would exist between persons dealing with each other at arms length.

Business Losses

The ability to carry forward business losses is a matter which requires careful consideration. A business loss can only be carried forward for application against profits arising from a similar business in which the loss was sustained. In the past there may have been some doubt as to whether the business in the loss and profit periods had to be of precisely the same kind and nature, but with decisions in the Exchequer Court in *M.N.R.* v. *Eastern Textile Products Ltd.* and *Ottawa Car and Aircraft Ltd.*, it seems clear that the business conducted in the loss period and in the profit period must be similar in nature. One method of minimizing losses (see above) is by eliminating the deduction of unpaid amounts under section 12(3), but a much simpler method is to refrain from claiming capital cost allowances and in effect thereby leave the loss in the fixed asset values on which capital cost allowances can be claimed in future years. It is often inadvisable to claim capital cost allowances which will reduce the taxable income below an amount of $20,000, the level up to which the minimum tax rates apply, because if capital cost allowances are claimed below the level of $20,000 the taxpayer is in effect parting with a portion of his asset value for a 20% or slightly higher tax recovery as against a 47% or slightly higher recovery which can be claimed when the taxable income exceeds $20,000.

Purchase and Sale of a Business

The purchase and sale of a business usually creates numerous tax problems for both the purchaser and vendor.

Generally speaking, the purchaser of a business carried on by an incorporated company will prefer to buy assets rather than shares. This is particularly the case if the price to be paid is based on an increase in fixed asset values over their values for income tax purposes in the hands of the vendor, since the assets must be purchased in order to use the enhanced price of the fixed assets as a base for calculating depreciation for tax purposes. On the other hand, the purchaser of shares of a company must recognize that the fixed asset values used for income tax purposes by the company acquired cannot be altered even though the price paid for the shares took into account enhanced fixed asset values. The vendor, whether a limited company or a non-incorporated business has to take into account that, if fixed assets are sold, there can be a recapture of depreciation taken since the beginning of the 1949 taxation year and of depreciation on certain classes of fixed assets on which special depreciation was allowed before 1949.

If shares, which constitute control, are purchased by another company, the purchaser must take into consideration that the surplus of the company acquired [illegible] the beginning of the year of acquisition will be designated under section 28(2) and dividends out of the designated surplus are taxable in the hands of the purchaser. On the other hand, if instead of a sale of shares the actual assets of the company are sold, then the company selling the assets may be subject to recapture of depreciation and the distribution of the assets of the company to its shareholders will involve them in liability to tax on

their portion of the company's undistributed income. The tax on distribution can be minimized by various steps but generally cannot be eliminated. In calculating undistributed income it is necessary to take into account the fact that if depreciation is recaptured there will be an increase in the amount of the undistributed income of a company by the difference between the amount recaptured and the income tax payable on the recapture.

Where assets rather than shares are being purchased, the purchaser and the vendor should consider the provisions of sections 85D and 85E covering the sale of accounts receivable and inventory. If the vendor is a company and has lump sum pension fund payments which have not yet been claimed for tax purposes, deduction can only be claimed by the vendor company and not by the purchaser of assets.

Provincial Corporation Tax

At the moment one of the most difficult problems in tax compliance is that which has resulted from the reentry of the Provinces of Quebec and Ontario into the corporation income tax field. Over the years since 1947 when the Province of Quebec reimposed a corporation income tax, the different definitions of what constituted carrying on business and having a permanent establishment in the Province of Quebec under the federal and provincial Acts has frequently resulted in duplicate taxation of the same income, which is completely inequitable to the taxpayer. These different definitions have often resulted in the Province of Quebec collecting corporate income tax at its normal rate on an amount of taxable income arrived at by allocating income as being earned in that province on the formula basis adopted by Quebec. The federal authorities have either denied any tax credit in respect of the Quebec income tax because they did not consider that the company involved was carrying on business through a permanent establishment in the Province of Quebec or else allowed only a partial credit for the Quebec tax because of using a different formula from Quebec for the purpose of allocating taxable income.

Now that the Province of Ontario has entered the field, there will be further inequities and unnecessary work in filing income tax returns unless the federal and provincial authorities can and do agree on a common formula for allocating income as between provinces and determining what constitutes carrying on business and having a permanent establishment within a province. While there have been indications that agreement has been reached, there has been no formal action to place the taxing provisions of the three governments on the same basis. This would appear to be one of the most important matters in the corporate income tax field now facing business. Failure to solve the problem could only lead to business enterprises adopting devices such as separate corporations within each province, all of which add to their costs and in addition create unnecessary complications for the executive in managing the business.

Direct Costing

ALPHONSE RIVERIN

BUSINESS GROWTH has created complex administrative problems. To face them administrators need more information in a form they are able to understand. Management's essential task is to make decisions in every phase of business transactions. Enterprises must be so managed as to furnish people with all that our modern standard of living requires. Natural resources have to be explored and worked, durable goods have to be produced, food and shelter must be made available to people, and so forth.

Management has to choose among goods to produce. It must set up a fair price appealing to clients and meeting competition. It must plan the location and expansion of the firm in order to get a proper share of trade. Every decision must be based on solid information provided by accounting, economics and marketing analysis.

Cost accountants have developed systems that provide management with some information, usually timely and useful but frequently little understood by administrators. Absorption costing has long been the only way accountants thought information should be conveyed. However, for many years now, another system, called direct costing, has been adopted to an increasing extent.

This system for providing cost information has created antagonism among those who support the more traditional method. One may say that it has become a controversial issue. This article is intended to set forth the pros and cons of direct costing.

What Direct Costing Is

First, it has to be stated that the procedures used in conjunction with direct costing do not convey the meaning usually attached to direct costs. In cost accounting direct costs are the costs directly identified with the product, such as direct labour and direct material. All other costs are called overhead or manufacturing expenses. The cost of the product, under absorption costing, includes direct material, direct labour and overhead.

Under direct costing all the variable manufacturing costs (direct and indirect) are included in the cost of the product, all other costs being considered as period costs and charged off currently to profit and loss instead

of to cost of sales. However, selling and administrative expenses are not included in the cost of sales, and consequently in inventories are taken into account before arriving at what is called the marginal income. Therefore, the method would be better described as variable costing.

The essential difference between absorption costing and direct costing is that the first emphasizes the distinction between production costs and all other costs whereas the second emphasizes the distinction between fixed costs and variable costs. Absorption tends to stress inventory valuation whereas direct costing is primarily interested in cost analysis.

In exhibit 1, an example has been set up showing the differences in profits arising out of the two methods. From the study of this exhibit, the following inferences can be made:

1. When sales and production are the same, there is no difference in profits.
2. When production is lower than sales, profits are higher under direct costing because there is no fixed overhead coming from inventory charged to cost of sales.
3. When production is higher than sales, profits are higher under absorption costing because of fixed overhead having been carried to inventory.
4. When sales are constant and production varies, the direct costing method shows a gross profit ratio more constant.
5. Variances in profits due to any one method tend to zero in the long run. Production and sales can vary over short periods, but a business can never sell more than it produces.

Positions of Professional Bodies

Direct costing is not yet used by a sufficient number of companies to be called a generally accepted principle of accounting.

Moreover, accounting associations have not yet given official recognition to this new convention. In bulletin No. 43, which superseded all its previous bulletins, the American Institute of Certified Public Accountants did not speak of direct costing as such, and the bulletin is not very clear as to the position adopted. In the chapter on inventory pricing, Statement No. 3 reads: " . . . cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location". But in the following paragraph, it is stated; " . . . general and administrative expenses should be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs. Selling expenses constitute no part of inventory costs." Yet it is further stated: "It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure." This last sentence leaves an open door to direct costing. If it is not proper to exclude all overheads from inventory costs, it might be proper to exclude only fixed costs.

On the other hand, the American Accounting Association adheres strictly to the cost principle in its statement on Accounting Concepts and Standards Underlying Corporate Financial Statements: "Adherence to the cost basis of accounting requires that there should be no suppression or unwarranted assignment to ex-

Exhibit I

	1953	1954	1955	1956
Production	5,000	3,000	4,000	5,000
Units sold	5,000	5,000	3,000	6,000
Variable manufacturing cost (unit)	$ 1.50	$ 1.50	$ 1.50	$ 1.50
Variable selling and administrative costs	.50	.50	.50	.50
Fixed manufacturing costs	1.00	1.00	1.00	1.00
Selling price	5.00	5.00	5.00	5.00
Total fixed costs	5,000.00	5,000.00	5,000.00	5,000.00
Fixed selling administrative expenses	2,000.00	2,000.00	2,000.00	2,000.00

PROFIT AND LOSS STATEMENT

Absorption Costing				
Sales	$25,000	$25,000	$15,000	$30,000
Cost of sales	12,500	12,500	7,500	15,000
	$ 2,500	$12,500	$ 7,500	$15,000
Unabsorbed overhead		2,000	1,000	
Gross profit	$12,500	$10,500	$ 6,500	$15,000
Fixed and variable general expenses	4,500	4,500	3,500	5,000
Net income before taxes	$ 8,000	$ 6,000	$ 3,000	$10,000
Direct Costing				
Sales	$25,000	$25,000	$15,000	$30,000
Variable manufacturing costs	7,000	7,500	4,500	9,000
	$17,500	$17,500	$10,500	$21,000
Variable general expenses	2,500	2,500	1,500	3,000
Marginal income	$15,000	$15,000	$ 9,000	$18,000
Fixed manufacturing costs	5,000	5,000	5,000	5,000
	$10,000	$10,000	$ 4,000	$13,000
Fixed general expenses	2,000	2,000	2,000	2,000
	$ 8,000	$ 8,000	$ 2,000	$11,000

pense of the costs of existing assets."

In its Research Bulletin No. 5, The Canadian Institute of Chartered Accountants seems to recognize the two methods. In effect, it says, the cost of finished goods in inventory includes the price of raw material, direct labour and usually the share of overhead that can be traceable to production. On the other hand, the Institute recognizes implicitly direct costing when it states that in some cases it is proper not to include fixed overhead if its inclusion would impair the significance of the profit figure due to fluctuations in the volume of production.

From the positions taken by professional associations, it can be seen that no agreement has been reached. It should be noted, however, that practising accountants seem almost ready to accept the direct costing method in view of its practicability and simplicity.

Advantages of Direct Costing

Direct costing has been devised to produce useful statements more easily understood by management. It shows clearly, without requiring any additional work, the cost-volume-profit relationship. Hence by looking over the report, management sees the effect of production and sales variances on profits. As the profit figure is not influenced by the fixed costs which must be incurred whether the facilities are producing at full capacity or not, direct costing makes administrators more conscious of the importance of costs. It also reveals the influence of fixed costs on net profit before taxation.

Once all variable costs (variable manufacturing, selling and administrative costs) have been deducted from net sales, the remainder is the contribution of operations to fixed costs and profits. This figure, usually called marginal income, is very useful to management. When it is expressed as a percentage of sales, it gives the marginal income ratio which allows the computation of the break-even point by dividing fixed costs by this ratio. This essential computation brings to light the sales figure above which the firm is building profit and under which it paves the way to failure.

Moreover, direct costing supplies the data needed by management in profit planning, make-or-buy decisions, pricing decisions, and decisions relating to capital expenditures, whether for replacement, cost reduction or expansion.

Any item which covers part of overhead increases the net profit of the firm. All products do not contribute equally to profits. Thus when information is given in detail by departments and by products, eliminating the fixed costs from the computation, it allows management to make decisions as to what item is more profitable, what lines should be promoted and to what extent a non-profitable item can contribute to fixed costs. Hence pricing is facilitated and selective selling can be made. Undoubtedly, absorption costing could give the same information, but with much more clerical work, since its procedures are not directed to that end.

Due to proper classification of expenses, it is possible to place responsibility for variable and fixed costs control. Fixed costs are no longer classified by departments or function but by item of expenses.

Cost information should not be more expensive than the value of its service to management. By developing cost information only when it is useful, direct costing has the advantage of simplicity and economy.

Inventory valuation derived from direct costing does not always comply with generally accepted accounting principles. However, because of its usefulness for internal reporting, it should not be an insurmountable problem for external reporting. To bring inventory into conformity with accepted practice, the procedure is to add or subtract from the inventory figure obtained by direct costing the amount of fixed costs that would otherwise have been taken into account under absorption costing.

To take this step is to resort in large measure to what absorption costing does, except that in direct costing it is done probably once a year, while in absorption costing it occurs constantly.

Disadvantages of Direct Costing

The most difficult problem in direct costing seems to be the classification of costs as variable or fixed. Even in practice some costs that pertain to the cost of production are classified as periodic costs due to the complication resulting from their allocation to products. A good example would be discounts on purchases which are often classified as period costs because of the difficulty of assigning them to the proper batch of raw material.

Variable and fixed costs are classified by the following principle: fixed costs are those providing the capacity to produce and expiring with the passage of time, regardless of extent to which the facilities are actually utilized. All other costs traceable to products are considered to be variable costs because if there was no production, such expenses would not have been incurred.

Consequently, fixed expenses are treated as profit-reduction items, not as value-creating items. This position is quite objectionable since if there were not any facilities to produce, there would not be any production at all. Facilities are used to create values, not reduce profits.

Moreover, some expenses usually considered fixed are sometimes variable, whereas other expenses ordinarily classified as variable are fixed. For example, the depreciation charge takes into account wear and tear of the facilities and their obsolescence. Only the latter can be said to expire with the passage of time. The first is due to the use of facilities. Consequently it is as variable as direct material or direct labour.

In some companies a large part of direct labour is fixed and will not vary with production volume. This is usually true of the highly-skilled groups of workers. Whether or not to separate these expenses into variable and fixed depends upon the proportion that the costs bear to the total cost of production.

In its essence, direct costing is an application, at the accounting level, of the traditional marginal analysis which may be stated this way: marginal cost is attained at the level of output where the incremental unit cost (traditionally presumed to increase as output increases) is equal to the price per unit which may be obtained for that output.

The conclusions reached by marginal analysis as to price policy and

output are applicable only to short run analysis and are valid only in the short run. Obviously, a firm that would take into consideration only variable cost in pricing its products would gradually consume its investment in long life assets and cease to exist as a going concern. Consequently, even if variable and differential costs are important for short run decisions, management cannot ignore the aggregate costs in planning the future strategy of the business.

It is often advanced that management must strive to maximize profits in the short run. However, nowadays another motivating force of management is the desire to assure the continued existence of the business with reasonable profits.

As previously mentioned, direct costing understates the value of inventory for reporting purposes. In the balance sheet, the working capital ratio is thus understated. This situation might create some problems for credit purposes.

Finally, direct costing when first adopted prohibits comparison with any prior year, unless a good deal of extra work is done to change the past periods to a direct costing basis. There is also the lack of comparison with other firms in the same industry which have not adopted the direct costing method.

CICERO ON INADEQUATE DISCLOSURE

The following example of Roman accounting (circa 84 B.C.) is the reckoning of an official named Verres for moneys received and expended by him at a time when he was attached to the Consul in Gaul. This document, read out and ridiculed by Cicero, is certainly remarkable, for it provides the Roman State with nothing more than the bare bones.

> "I received," it reads, "2,235,417 sesterces. I spent on army pay, corn, the legates, the proquaestor, and the praetorian cohort 1,635,417 sesterces. At Arminium I left 600,000 sesterces." (Caesar's *Verrines*)

"Is this rendering accounts?" thunders Cicero. "What impertinence! What audacity! Whoever heard of accounts being rendered in this fashion?"

Apart from the cryptic brevity of the account, it was totally unsupported by vouchers. Yet it is worth a second glance, as it illustrates in a nutshell the form in which all Roman accounts were stated, i.e. in narrative. Debits and credits, cash columns (and, of course, Arabic numerals) were still far off in the future.

— *The Accountant,* August 10, 1957

Edited by LAWRENCE G. MACPHERSON, F.C.A.

Accounting Research

Director of Research, C.I.C.A.

The desire for uniformity and comparability in financial data sometimes leads investment analysts to reclassify financial statement items according to their best judgment, but on occasion the result may be somewhat different from the intention of those who made the original decisions in preparing the statement. A recent inquiry concerning such reclassification is dealt with in the following note prepared by Mr. T. A. Hutchison, F.C.A., chairman of the Committee on Accounting and Auditing Research:

Classification of Assets

Recent correspondence received by the Committee on Accounting and Auditing Research suggests that there may be some confusion in the minds of the investing public, and possibly in the minds of some accountants, as to the inclusion in current assets of cash surrender value of life insurance and prepaid expenses. A portion of a letter received from an investment advisory service, which is quoted below, indicates the nature of the problem:

> "Qualified auditors themselves do not seem to be able to come to agreement regarding cash surrender value of life insurance and prepaid expenses. Many include both as current assets, others include both as non-current. Because of this, these items cause much confusion and in our records we make some attempt to treat them consistently wherever possible.
>
> "Many auditors consider cash surrender value of life insurance as more current than accounts receivable. It is a very readily realizable asset and might be treated as a very high grade investment. On the other hand, prepaid expenses often include a variety of items such as prepaid taxes, etc. on which there is no recoverable value at the end of a year. Because of this difference one is treated as current and the other as non-current, in many instances."

The committee considers that this problem only exists because of confusion in the minds of the investing public as to the basis on which items are included or excluded from current assets. The essential principle involved in determining that an item may be included in current assets is that the asset will normally be realized within a period of one year or within the normal operating cycle of the business. In the case of prepaid expenses the items should represent costs which will be absorbed in the operating cycle. This, of course, excludes deferred charges, such as bond discount and expenses, since they are usually absorbed over a period of years.

The fact that an asset can readily be converted into cash does not of itself justify its inclusion in current assets, if in fact there is no intention in the ordinary course of business to make the conversion into cash. Frequently life insurance is carried by a company on the life of one or more

of its principal officers, so as to protect the business enterprise from the loss of profit which may arise from the death of an important executive officer. Under these circumstances, the possibility of converting the cash surrender value of the life insurance into cash is exceedingly remote since the intention will be to continue the life insurance until the death or retirement of the officer involved.

On the other hand items usually included in prepaid expenses such as insurance, taxes and operating supplies represent costs which are normally absorbed in the operating cycle of the business enterprise. It is true that these assets may not be directly converted into cash but in fact by entering into the operating costs of the enterprise recoverable from operating revenues, they become part of the cash flow just as much as do inventories.

DUPLICATE DEPOSIT SLIPS

The following letters have been received in response to the request for comments on the suggested plan in connection with duplicate deposit slips, referred to in this department in August, 1957:

Toronto, July 31, 1957

Sir: I am not a member of your Institute, but may I comment on the "suggested plan", to strengthen the check on deposits, appearing on page 143 of *The Canadian Chartered Accountant*, August, 1957? Excellent as it is, it would be improved by arranging for the bank to return slips daily, by mail, directly to a senior officer. To leave them until the usual monthly statement gives far too much opportunity for fraud, as I have learned from experience.

N. J. NOTLEY

Toronto, August 15, 1957

Sir: Although not now engaged in audit work, I would like to make the following comments on the suggestion regarding duplicate deposit slips appearing in the Accounting Research Department for August:

Paragraph 2 indicates that the senior officer receiving the slip will check the duplicate against the records.

Paragraph 3 on page 144 suggests that the duplicate may be in possession of the bank for a considerable period of time.

From this it would seem that there may be delays in checking the records with the duplicate slips which might thereby prolong a period of misappropriations.

Full accounting for sums received would appear to be something best ensured through proper internal control within the company.

As part of that control, I would suggest that a reasonably senior person—in no way directly associated with receivables or accounting for sums received—would initial each deposit slip after checking in detail with actual remittances, and the slip and deposits would then be passed to some one in no way connected with receivables or cash accounting to be taken to the bank. Periodically, the person checking the deposit slip would check the detail with the records — including in particular confirmation that correct payor or account has been credited (to ensure

that misappropriations are not being covered up) — and would either initial the record or keep a memorandum of dates checks made.

From the public auditing viewpoint, I wonder whether banks would find it less onerous and auditors would find it equally acceptable if, on special request from auditors, banks were to make detailed checks of deposit slips and notify auditors of any discrepancies. Such checks might be made at any time on due notice but would obviously have to be for short periods to encourage cooperation from the banks.

Finally, I wonder whether banks would consider differently coloured deposit slips for cash and cheques which in any case might be useful to them to facilitate computation of cash receipts and which would prevent dishonest cashiers showing cheques as cash, assuming that the banks would at least check that deposits recorded on a cash deposit slip were actually made in cash.

C. L. Watson
Secretary-Treasurer
Electric Reduction Company of Canada, Ltd.

"FINANCIAL REPORTING IN CANADA" (SECOND EDITION)

The second edition of "Financial Reporting in Canada" will be released early this month. This book incorporates the results of studies of the accounting aspects of financial reports issued annually by Canadian industrial and mercantile companies to their shareholders. In this second edition, the analyses have been expanded to include 300 companies and to provide a four-year comparison (1956, 1955, 1954 and 1953).

Although designed along the basic pattern of the first edition, released in October 1955, the statistical tabulations and general commentary have been increased to provide more complete coverage of current accounting and financial reporting practices in this country. Some 60 tables have been included in this new study as opposed to 45 in the first edition, and the book runs to slightly over 100 pages compared with 71 in the previous issue.

The tables provide a factual record of current reporting practices with respect to such diverse matters as types of financial statements presented, the form and terminology employed, the accounting treatment accorded the transactions and items reflected in such statements, and the form and content of the auditor's report. Particular emphasis has been placed on topics covered in the bulletins issued by the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants, and comparisons are made, in some areas, with the current practices followed by American publicly-owned corporations.

Marquis G. Eaton, president of the American Institute of Certified Public Accountants, recently stated, "Financial reporting as a discipline is relatively young. At the beginning of this century corporations reported whatever they pleased, if anything, and kept their accounts according to their own best notions. Independent audits were not required, and the accounting profession was a mere in-

fant." Mr. Eaton noted, however, that there had been impressive progress in the last forty years but cautioned that "the fact that much progress has been made does not mean that all of the problems of accounting are being solved. We must squarely face the possibility that economic and social changes may be creating new problems at least as rapidly as older ones are being liquidated."

The second edition of "Financial Reporting in Canada" clearly shows that in Canada, as in the United States, considerable progress has been made in the development and acceptance of effective financial reporting techniques. However, variations in accounting treatment and reporting practices seem to indicate inconsistencies and misunderstanding in certain areas. This is particularly true of the many new problems created by the expanding complexities of modern business activities and by changes in regulatory statutes. Although it is recognized that alternative treatments are often equally acceptable, the research staff has not hesitated to draw attention to those which are ineffective. A particular procedure is not considered the most adequate merely because it is the most common.

The new and expanded edition of "Financial Reporting in Canada" should make a very definite contribution to the progress in financial reporting in Canada. To those who are seeking direction in this particular field, many of the usual practices reflected in the statistical tabulations represent basic principles of fair reporting. For those who have already achieved a high degree of effectiveness, the survey brings to light certain areas of weakness where common current procedures fall short of fulfilling minimum standards of disclosure. The Committee on Accounting and Auditing Research is confident that members of our profession and management of Canadian business enterprises will find this current study an extremely interesting and useful document.

BY A. WILLARD HAMILTON, C.A.

Tax Review

Interest Paid

Prior to 1950, paragraph "c" of section 11(1) of the Income Tax Act relating to the deduction of interest was quite restrictive in application and the majority of cases were decided against the taxpayer. The 1950 and subsequent amendments broadened the scope of the paragraph materially and a review of its present application and certain related sections of the Act would appear to be timely.

Interest has been described briefly as "rent paid for the use of money". It is defined in Webster's dictionary as "the price or rate of premium per unit of time that is paid by a borrower for the use of what he borrows, a rate per cent of money paid for the use of money or the forbearance of demanding payment of a debt".

This definition does not, however, cover the case where interest is payable by statute: for example, under the Income Tax Act where interest is chargeable on arrears of taxes. Statutory interest, therefore, should be included in any review of the subject.

It must be noted that the mere use of the word "interest" does not automatically so classify the amount involved and the warning (*In re Ramsay* (1946), 1 W.W.R. 510) should be duly heeded:

> Whether an amount received by a taxpayer is interest will not necessarily depend upon whether it is described as interest in the contract or other document on which the claim is based. It is necessary to look at the pith and substance of the transaction.

In order for interest to be deducted under section 11(1)(c) the following qualifications must be met:

(1) The amount of interest must be paid *in* the taxation year, where the taxpayer is on the "cash" basis of accounting;

(2) Interest may be accrued, although unpaid, by a taxpayer who follows the "accrued" basis of accounting;

(3) The claim for deduction must be based on a legal obligation to pay interest (i.e. enforceable rather than voluntary);

(4) The obligation must represent
   - (a) borrowed money used for the purpose of earning income from a business or property

     or
   - (b) an amount payable for property acquired for the purpose of producing income

     provided
   - (c) income from the property would not be exempt (exempt income includes dividends from taxable Canadian corporations (s. 28));

(5) The amount (rate) must be reasonable.

It should be noted that the provisions in paragraphs (a), (b) and (h) of section 12(1) are rendered inapplicable to the provisions of section 11(1)(c) by virtue of the pre-

amble to section 11(1). However, as such provisions are relevant to this discussion, they are enumerated below:

No deduction shall be made in respect of:

(1) An outlay or expense, except to the extent that it is made or incurred for the purpose of gaining or producing income from a property or business (s. 12(1)(a));

(2) An outlay, loss or replacement of capital, a payment on account of capital, or depreciation, obsolescence and depletion allowances, except as expressly permitted by Part I of the Act (s. 12(1)(b));

(3) Personal or living expenses, except travelling expenses incurred while away from home and in the course of business (s. 12(1)(h)).

It should be observed also that section 12(3) remains applicable to disallow interest accrued in a non-arm's length transaction where it is not paid by the end of the fiscal year following that in which the accrual is made.

As already indicated, the courts have tended to give a strict interpretation to section 11(1)(c) of the Act. If the taxpayer is unable to show that he is entitled to a deduction of interest under the general provisions of that paragraph, or other specific sections mentioned below, the deduction of interest will be disallowed as falling within one of the above-mentioned exclusions contained in section 12(1).

There are several other specific sections in the Act dealing with interest which should be mentioned, following which reference will be made to a number of items which are, or are not, deductible under section 11(1)(c).

Compound Interest (s. 11(1)(ca))

Effective with the 1954 taxation year, compound interest became a deductible expense. Such interest, however, must be pursuant to a legal obligation to pay and the interest upon which the interest is compounded must itself have been deductible under section 11(1)(c). Prior to the passing of section 11(1)(ca), compound interest was not deductible due to the absence of a borrower-lender relationship, i.e. the simple interest had not been "borrowed".

Interest on the Discounted Portion of a Loan (s. 11(3a))

Where loans are made with the face value in excess of the amount actually borrowed, the interest paid on the discounted portion is deductible under section 11(3a) if the interest on the loan qualifies for deduction. Prior to the introduction of section 11(3a) in 1954 this was not so, the Supreme Court of Canada having held, (*Stock Exchange Building Corporation*, January 25, 1955), that a borrower and lender relationship did not exist with respect to the discounted portion of such a loan.

Section 11(3a) also provides for the division of the interest on the discounted portion between amounts borrowed to earn income from a business or property and non-taxable items, interest of course not being allowed on the latter.

Interest Included in Lump Sum Payment (s. 11(1)(d))

If a payment of an amount can reasonably be regarded as part payment of interest, then the part so regarded is included in income under section 7.

A taxpayer who makes such a payment can claim the interest portion as a deduction under section 11(1)(d) if it is made as

(1) a repayment of borrowed money, or

(2) a payment for property used for the purpose of earning income. The income earned cannot be tax-exempt income.

However, it does not follow that if the contract calls for lump-sum payments that part thereof will necessarily be interest. In the case of *Baril* (ITAB, March 21, 1957), the appellant sold by deed his rights to an estate for $50,000, payable in instalments of $100 weekly. The purchaser of the estate divided the payments into principal and interest, and for the year 1954 filed a return with the Minister of National Revenue, indicating that $1,372 of the total payment, for the year, was interest. The Board held that as the capital value of the estate at the time of sale by the appellant was in excess of $50,000, "the sum he received therefor in 1954 cannot be reasonably regarded as being in part a payment of interest and in part a payment of a capital nature; the said sum was a payment of a capital nature only." The opinion was expressed that the purchaser had filed the return solely in order to claim a deduction from his own income under section 11(1)(d).

Interest on Income Bonds (s. 12(1)(f))

Interest on income bonds is normally considered to be a dividend. The Income Tax Act spells this out and the interest will be so treated unless it can be shown that the bonds qualify as replacements for bonds outstanding at the end of 1930 which called unconditionally for a fixed rate of interest and that the said bonds were issued to afford the debtor relief from financial difficulties. There is a complementary provision in the Act (s. 8(3)) which ensures that this type of interest will be included in income of the recipient if it is allowed as an expense to the payor.

Interest on Bonds Sold (s. 19(A))

This section provides for the proration of interest between a purchaser and vendor of bonds so that the transferee of a bond is entitled to deduct from his income such portion of the interest payments received as was earned before he acquired the bond. Division of the interest is made on a daily basis.

Interest on Succession Duties (s. 11(1)(o))

The deduction for interest on succession duties, as provided in section 11(1)(o), is granted only when the interest is paid directly to the taxing authority in question. It does not permit a deduction of interest charges where funds are borrowed to pay duties. The Income Tax Appeal Board in the case of *No. 185* (August 12, 1954), where the appellant's estate borrowed money in order to pay succession duties and then claimed a deduction of interest on the ground that the borrowing permitted the retention of securities which otherwise would have had to be sold and thus was earned income for the estate, held that the interest was not deductible as there must be a direct cause and effect between the borrowing and the earning of the money.

Interest paid by a Non-Resident Owned Investment Corporation (s. 70)

Interest so paid is not deductible in computing the taxable income of

an N.R.O. investment corporation, because of the special treatment afforded these corporations in the Act.

The following comments relate to the general question of deductibility of interest items of various kinds.

Interest on Borrowed Money Replacing Borrowed Money

When the application of section 11(1)(c) was broadened in 1954 an additional paragraph (3b) was added for greater certainty. This latter paragraph prohibits the deduction of interest paid on a replacement loan unless interest on the original loan was deductible under either paragraph (c) or (d) of section 11(1). That is to say, a taxpayer cannot refinance in order to obtain an interest deduction that he was not entitled to formerly, a possibility which the Income Tax Appeal Board had suggested prior to the introduction of section 11(3b).

Interest — Tax-Exempt Income

There is in the Act a prohibition against the deduction of any expense laid out for the purpose of gaining or producing exempt income and section 11(1)(c) reiterates this prohibition in respect of interest expense. However, the determination of the amount of interest which relates to property, the income from which would be exempt, is not always an easy matter to determine. This is illustrated in case *No 419*, ITAB, April 29, 1957. In this case an incorporated taxpayer, having temporarily financed the purchase of the shares of another company at a cost of approximately $500,000, shortly thereafter issued debentures in the amount of $800,000 and repaid from the proceeds thereof a bank loan and the balance owing on the shares. The interest on the debentures was disallowed under section 11(1)(c) and the taxpayer appealed. Where a taxpayer claims an exemption it must come squarely within the wording of the section and, in the present instance, this could not be done. It would seem to follow, however, that where a taxpayer can produce a "source and application of funds" statement, it would be possible to claim the deduction of that portion of interest on the capital not invested in property, the income from which would be exempt.

"For the Purpose of Earning Income"

While the deduction of interest is contingent upon the condition that the payment has been made for the *purpose* of gaining or producing income from a business or property, or for property acquired for the purpose of gaining or producing income, the taxpayer's position becomes much stronger if he can show that income has resulted, rather than to rely, sans income, on proving the rather difficult fact that the *purpose* of borrowing had been to produce taxable income. In the case of *Demers* (ITAB January 28, 1952) interest on money borrowed to reloan as a non-interest bearing loan was held to be non-deductible. As a general rule, in the administration of the Act, interest on unimproved property is not considered deductible, while interest on improved property is considered as deductible. There is a possibility, however, that where a property is held for an undue period of time without any income being produced the interest will be disallowed.

Unreasonable Interest

The question of what is a reasonable amount or a reasonable rate of interest is always one which can only

be judged in the particular circumstances involved. Where a high degree of risk is present a considerably higher rate of interest would appear to be justified but, as already indicated, the interest factor must be "pure" and the charge must not include other elements, such as a premium.

Interest on Income Taxes

It is hardly necessary to note that interest on income taxes has never been allowed as a deductible expense, although many representations have been made to the Minister of Finance that, in equity, interest should be so allowed because of the fact that interest received on overpaid taxes is invariably added to the income subject to tax.

Interest as Discount

As stated in a preceding paragraph, discount is normally treated as a capital loss (s. 12(1)(b)), as representing a payment on account of principal indebtedness. If, however, it can be shown that the discount is in "pith and substance" interest then the deduction would be permitted by section 11(1)(c). This position could probably only be maintained if money were loaned without interest or at an abnormally low rate of interest. The moral is that the payor of interest should make sure that his accounts reflect all interest charged at reasonable rates and proper amounts. (See *Matchett,* ITAB May 22, 1957.)

Bonuses on Borrowed Money

Such amounts have been held not to constitute interest and are not deductible, in view of the fact that they are an integral part of the capital to be reimbursed and, by virtue of section 12(1)(b), considered as payments on account of capital.

Interest on Money Borrowed to Pay Dividends or Redeem Capital Stock

It is questionable whether interest of this nature meets the requirement of being paid on amounts borrowed for the purpose of earning income. However, there usually exists administrative leniency in this respect as it is often difficult, if not impossible, to identify funds borrowed for these purposes, and as a rule, therefore, such interest is deductible.

Interest Paid During Construction Period

Interest paid on balances due on capital construction account or for bonds used to finance capital expenditures is allowed as a current expense laid out for the purpose of earning income, even though in a new organization this may result in the creation of a loss to be carried forward against subsequent profits. The taxpayer, naturally, cannot add the relative amount to his fixed asset accounts, as capital cost allowances would then give him a duplicate deduction for the one expenditure.

Interest on Property Taxes

While under a strict interpretation of section 11(1)(c) interest on property taxes might not be allowable, the deduction of such interest is generally permitted by the administration as part of taxes expense. (See, however, above remarks re interest on unproductive property.)

Interest on Bonds Being Refunded

It has been well established by various cases that interest paid on a bond issue that is being refunded will

not be permitted in addition to a deduction of the interest on the replacing issue, the deduction being limited to interest on one principal amount only.

Interest on Personal Mortgages

Interest does not qualify as a deduction which is paid on a personal mortgage unless the property concerned is producing income. In the case of *Carswell* (ITAB, November 19, 1951), the taxpayer contended that the funds were not, in fact, borrowed for personal purposes as certain securities which he held could have been sold. The Income Tax Appeal Board felt that this suggestion was beyond a reasonable interpretation of section 11(1)(c).

Interest on Securities Purchased

Where the taxpayer purchases income bearing securities, the carrying charges on such securities may be offset against dividends and interest received. Where his securities are maintained in a margin account with a stockbroker, on which he is required to pay interest, he is entitled to deduct the interest paid to his broker.

Interest on Partners' Capital

Many partnerships pay interest on the capital contributed by the several partners but such payments are not considered as interest within the provisions of the Act, but merely a method by which the partners apportion the profits of the partnership.

Excerpt from letter to the Tax Department claiming a dependent relative:

"Teresa and Mary are well over 70 and have lived with my uncle for years. He is a dealer in antiques."

—*Taxes,* April 1957

BY PETER C. BRIANT, B.COM., C.A.

Current Reading

MAGAZINE ARTICLES

ACCOUNTING

"ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL MANAGEMENT AND PRECEDING STATEMENTS AND SUPPLEMENTS"; published by the American Accounting Association; pp. 64; 50c.

This excellent little booklet, containing every "statement" and "supplementary statement" issued by the American Accounting Association since 1936, would be a useful and inexpensive addition to any accountant's library. Presenting the considered opinions of committees comprising some of the foremost professors of accounting in the United States, these statements are considerably different in form and scope from the bulletins published by the Canadian and American Institutes. The general objective of them all is well stated in the introduction to the 1957 statement entitled "Accounting and Reporting Standards for Corporate Financial Statements":

> The purposes of this statement are to present the concepts fundamental to accounting, and to suggest standards to which general purpose reports to stockholders and others interested in corporate business enterprise should conform, and by which existing accounting practice may be judged . . .

Of interest in its current statement is the committee's position with regard to the treatment of income taxes where revenues or expired costs are recognized in one period for business purposes and in an earlier or later period for tax purposes. A majority of the committee does not favour recording the difference between the actual tax liability and the book tax liability as a prepayment or accrual. These items do not present the usual characteristics of assets or liabilities, they state; the possible future offsets are often subject to unusual certainties; and treatment on an accrual basis is in many cases unduly complicated. Disclosure by accrual, the statement says, may be more confusing than enlightening.

In a dissent to this view, Professor Maurice Moonitz maintains that the prospects of substantial reduction or repeal of the corporate income tax are negligible, and that the prospects of profitable operation of corporate enterprise are extremely high. The future tax obligation or benefit is, accordingly, sufficiently certain to warrant inclusion in the accounts and financial statements, he asserts.

Copies of this publication may be obtained by writing to the Secretary-Treasurer, Professor Carson Cox, College of Commerce and Administration, Ohio State University, Columbus 10, Ohio.

"FINANCIAL REPORTING IN A CHANGING SOCIETY" by Marquis Eaton. *The Journal of Accountancy,* August, 1957, pp. 25-31.

In a significant address, the president of the American Institute of Certified Public Accountants raises

some important questions concerning the determination of business income and discusses the responsibility of public accountants, business managements and other economic groups in efforts to improve our system of financial reporting, which is "one thing," he says, "that holds our economy together."

> Accounting is not a natural science, but a social science. It measures and communicates information about economic activities, which, because they involve human motivations and judgments, are in themselves dynamic and unstable . . .
>
> . . . the fact that much progress has been made (in standards of financial reporting in the last forty years) does not mean that all of the problems of accounting are being rapidly solved. We must face squarely the possibility that economic and social changes may be creating new problems at least as rapidly as older ones are being liquidated . . .
>
> The income tax, for example, has spawned a whole new set of dilemmas. Its influence is powerful but not always healthy . . .
>
> Perhaps the most significant of these recent developments has been the steady decline in the purchasing power of the currency . . . The question is whether changes in accounting principles can compensate for the imperfection of money as a common denominator without sacrificing other vital purposes of financial reporting . . .
>
> The accounting profession, through the Institute has accepted the responsibility of leadership in the incessant search for better methods of financial reporting. But it does not have, cannot assume, and in my opinion should not permit itself to be regarded as having the *sole* responsibility for the results . . .
>
> Obviously corporate management does have and must have a part in determining the broad objectives and basic assumptions underlying corporate financial reporting . . .
>
> Government, too has a responsibility to exercise its taxing powers and its regulatory powers in a way that will facilitate, rather than impede, sound financial accounting . . .
>
> It would be a great misfortune for American business, and the whole economy, if uniform accounting rules were to be prescribed by government fiat. It would probably mean the end of progress. The Interstate Commerce Commission did exactly this in 1914 for the regulated railroads . . . By 1957 the ICC accounting classification was completely out of date . . .
>
> Other groups, such as bankers, financial analysts, economists, and financial editors, may have some responsibility to advise how financial statements may be made more useful for the purposes they are intended to serve . . .

MANAGEMENT

"LISTENING TO PEOPLE" by R. G. Nichols and Leonard H. Stevens. *Harvard Business Review,* September-October, 1957, pp. 85-92.

In their research on the effectiveness of the spoken word, the authors of this article found that immediately after the average person has listened to someone talk, he remembers only about half of what he has heard. The problem, they write, is caused by the fact that we think much faster than we talk. Consequently, we can listen and still have some spare time for thinking. Efficient listening thus seems to depend on using this spare thinking time to direct a maximum of thought to the message received. The following four processes are suggested as contributing to this end:

1. Think ahead of the talker and try to anticipate what the oral discourse is leading to.
2. Weigh the evidence used by the talker to support the points he makes.
3. Periodically, review and mentally

summarize the points of the talk as far as it has progressed.

4. Search for meanings not put into the spoken words by paying attention to non-verbal communication (facial expression, gestures, tone of voice) to see if it adds meaning to the spoken words.

This article takes on added importance when it is realized that the authors have found that business executives and professional men spend 80% of their time listening to people.

TAXES

"Some Arguments against the Inter-Period Allocation of Income Taxes" by Thomas M. Hill. *The Accounting Review,* July, 1957, pp. 357-361.

In a masterful presentation, Professor Hill of Massachusetts Institute of Technology points to the weakness inherent in showing the difference between a current tax payment and the amount of tax properly ascribed to the current period as an asset or liability.

Illustrating his argument by reference to the use of accelerated depreciation for tax purposes and straight-line depreciation for reporting, he emphasizes the difficulties that normally may be expected to arise when a firm expands its plant or maintains a reasonably uniform rate of plant replacement. "The accelerated charges on newly acquired assets may, in any future period, equal or exceed the then decelerated charges on the old assets," he writes. "Consequently, the postulated increase in tax payments may be distributed over future periods in an indeterminate manner, or may be entirely deferred until such time as the firm ceases fully to replace worn out and obsolete plant elements." He therefore believes that to quantify the "prepaid income tax" or "liability for future income tax" with precision, accountants will be faced with the seemingly impossible task of forecasting not only future tax rates and earning levels, but also the pattern of future acquisitions of depreciable assets.

Four distinct patterns of results seem to him to be emerging:

1. In an expanding firm, especially a large one, the amount of tax payments deferred will tend to increase steadily.
2. In a large and stable company, the amount of tax deferment built up in the first few years after adoption of an accelerated depreciation method will remain essentially constant.
3. In the smaller firm using major capital equipment and replacing spasmodically, the amount will vary irregularly in a manner difficult to predict.
4. In a company where the scale of operations is contracting, the mount will decline, but actual offsetting increases in tax payments may well not materialize because of a contraction in taxable earnings . . .

As a further complication, he sees the need to determine the expected time lag between the recording of the liability for future income taxes and its payments, so that it may be shown at its present burden by the application of an appropriate rate of discount.

These considerations lead Hill to reject the inclusion of all forms of inter-period income tax allocation in published financial reports. Instead, he would like to see all causes of differences between accounting net income and taxable net income shown in a supplementary schedule. With

two classifications, this schedule would distinguish between two types of adjustments: permanent adjustments, stemming from the fact that certain items of revenue and expense are legally excluded for tax purposes; and temporary adjustments, where the timing of net income determinants by the tax department differs from that of the corporation. The expected period or periods of offset would be revealed for the latter.

BOOK REVIEW

Neifeld's Guide to Instalment Computations, by Dr. R. Neifeld; Mack Publishing Co., Easton, Penn.; pp. 415; $8.80

This is a welcome book to all those who deal with instalment payment computations and allied problems. The author, Dr. Neifeld, whose educational background has been in the field of economics, is a director of the Beneficial Management Corporation and Beneficial Management Institute, Inc. He is the author of numerous books and articles and has appeared frequently in conferences both in business and economics circles on the wide and very significant subject of consumer financing.

His approach to the subject is practical, and the reader is allowed to skim over the mathematical bases from which the several formulae are developed to whatever degree he wishes, and can merely use the specific formulae to solve his own business problems without further study.

To those interested in methods of taking interest into income, there is a full discussion on the logic of the "Rule of 78ths" or "Sum-of-the-Digits" method. The various methods for calculating yields on instalment paper are fully explained and the variations in formulae caused by special features, such as holdbacks, balloon payments, etc., are also illustrated.

This is certainly a book easily understood by anyone, requiring little acquaintaince with the mathematical bases of the problems concerned and providing ready formulae to give answers to the many business problems involving rates, yields, capital requirements, accounting procedures, cost analysis and so on. It is a valuable reference work to all companies involved in instalment selling and to auditors who have clients with instalment sales.

A. R. Marchment, C.A.,
Toronto, Ontario.

SHORTER NOTES

"The Preparation of Consolidated Statements" by John Peoples. *The Journal of Accountancy*, August, 1957, pp. 32-36.

A member of the American Institute's committee on accounting procedure considers a number of controversial problems in consolidation practices and makes some suggestions for their solution. Guideposts as to when subsidiaries should be included or excluded from consolidated statements are also presented.

"Industrial Concentration," *Commercial Letter*, The Canadian Bank of Commerce. June, 1957, pp. 8.

A review of the growing problem of industrial concentration and a brief summary of the text of the study on industrial concentration in the United States, the United Kingdom and Canada prepared by the Canadian Bank of Commerce for the Royal Commission on Canada's Economic Prospects.

BY KENNETH M. PLACE, C.A.

Administrative Accounting

THE ACCOUNTANT IN INDUSTRY

If the average person was asked what an industrial accountant does, the answers would probably range all the way from a description of the simple recording operations of a bookkeeper to a straight-forward "I don't know". In fact, even people with an accounting background very seldom have more than a very general idea of the scope of his activities.

In actual practice, industrial accountants may be employed in many different areas within the modern industrial organization, but by far the majority are engaged in financial or control activities within the accounting or financial department of the organization. The functions of an accounting department can be classified under four main headings, depending upon the ultimate degree of responsibility:

1. *Service Functions*: Those for which the department is providing a service for other units at their request, because the receiving unit does not have qualified staff to carry out the work or because it is more economical for one unit to perform all such services.
2. *Coordinating Functions*: Those which, while they could theoretically be carried out by each department for itself, can be most effectively handled by one unit which has been delegated the responsibility. The manner of carrying out such functions is normally determined by the executing unit.
3. *Executing Functions*: Those which, by their nature, can only be carried out by one unit for the organization as a whole, the responsibility for which is delegated to a specific department or officer by administrative management or by clearly established business custom.
4. *Control Functions*: Those which must be carried out by the company in order to comply with requirements of statute law, civil law, company by-law or clearly established business custom, the responsibility for which is delegated to a specific department or officer by law, company by-law, administrative management or business custom.

Some of these functions are of a staff nature, others of a line nature. In most instances, the actual division and scope will differ with the degree of centralization of the particular organization and the degree of responsibility involved. Necessarily, the specific functions performed will differ among organizations, but there is a hard core which is common to all, i.e. those functions which are required to be performed by statute law, civil law or established business custom.

While the above breakdown into various classifications of responsibility sets the stage for considering the relative importance of the various types of operation, the typical accounting unit (for purposes of simplicity, all

accounting and financial work is included within this designation) is usually divided physically into three sections:

1. Accounting.
2. Financial.
3. Internal audit.

Within each of these physical divisions, the work performed can be classified functionally according to the four-part breakdown – service, co-ordinating, executing or control.

What work is actually performed? Within the accounting unit would be most of the technical accounting operations. Starting with service functions are found supervision and operation of any mechanical system, such as punched cards, which are used to accumulate information for sales analyses, etc. In the coordinating category is the overall design, installation and continuous review of accounting methods and systems throughout the organization. In classifying this function as coordinating, it is assumed the organization is largely decentralized. As the degree of centralization increases, it becomes more and more an executing function. It is, however, of major importance because the relative efficiency of the accounting methods and systems obviously governs the relative efficiency of the majority of the clerical work throughout the organization.

In ascending order of importance are those operations which can be classified as executing functions. Here the accountant starts to exercise a significant influence on the overall conduct of the organization, and sound accounting ability is a "must". In this category, for instance, are placed the preparation of all regular and most special financial reports, compilation of company profit forecasts, and calculation of payments due with respect to royalties, commissions (excluding salesmen) and other special items. At the present time, methods of handling large volumes of accounting data are being revolutionized by the influx of integrated data processing, electronic computers and similar methods of machine processing. A high degree of imagination and technical skill is a necessity if the greatest advantage is to be derived from the application of these new techniques.

The most important area of all, however, encompasses the control functions. The duties in this area include formulation and administration of accounting policy, including control of all accounting and financial records, as well as preparation of company financial statements, ensuring compliance with corporation tax legislation, including income, sales and excise tax returns, and the control of capital expenditures within the limits authorized by management.

What does the "financial" unit do? First, under the services classification, it maintains salary records and accumulates statistical information on remuneration as required for proper salary administration throughout the organization. Secondly, under the coordinating function are found the payment of suppliers' accounts, payment of salaries and pensions and remission of deductions from employees' remuneration for income tax, etc., to the proper authorities, settlement of estates of deceased employees and pensioners, administration of details of court orders covering salary or wage garnishments, and the maintenance of employee service records and other similar records. Thirdly, within the category of executing functions are the formulation and administra-

tion of cash and banking policies, design and operation of the banking structure, formulation and administration of credit policy, usually including the actual collection of accounts receivable, and assistance in the implementation of industrial relations plans. Lastly, as a control function, this unit is responsible for ensuring overall compliance with all tax legislation provisions respecting employee remuneration.

With the audit group, the situation is somewhat different. It is not likely that any of the responsibilities of the group will fall in the service category or, bearing in mind our definition, in the control category. Many companies today are realizing that the audit unit, because of its broad knowledge of overall company operations, is highly qualified to perform additional functions with a maximum degree of efficiency. While its basic function of auditing all records and procedures throughout the company is essentially an executing one, in many instances it is being assigned additional duties. Insurance is an excellent example. Because of the unit's intimate knowledge of each physical location and hence its ability to assess potential risks, it is ideally equipped to supervise an overall insurance program. As a part of its responsibility for the audit of records, considerable liaison must be maintained with those responsible for the design of new systems and improvements to the existing systems, since management must be satisfied in advance that the proper degree of control exists before any changes in its procedures take place. As a natural outcome, there is tendency in many companies to give this unit at least a joint responsibility for methods work.

The day-to-day functions of the accounting unit encompass a great many areas which do not fall within the narrow definition of accounting, but which must be done and which, in most instances, can be done efficiently by the accountant and his organization. Many other operations of a non-recurring nature fall to the lot of the accountant. These include investigating irregularities such as defalcations, reviewing financial information with respect to entry into new product fields or expansion in existing ones, taking a major role in the preparation of annual and other published financial reports, and studying the financial provisions of welfare plans.

The industrial accountant's duties can encompass a very wide range of responsibilities and functions, and the possibilities for his advancement are limited only by his own ability.

Editor's Note:

It is with regret that we must announce the resignation of Kenneth Place, C.A., as editor of Administrative Accounting. The department's first change of editorship takes effect with the December issue. Mr. Place's thought provoking and informative column has appeared each alternative month since August 1955 and the Editor takes this opportunity to express, on behalf of the readers, sincere thanks to Mr. Place for his excellent contribution to the magazine. The appointment of his successor will be announced when the department next appears in December. The July 1955 editorial referred to the introduction of this column as a means to promote a more comprehensive understanding of accounting in industry. This same policy will be carried on.

BY J. E. SMYTH, F.C.A.

Associate Professor,
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Students Department

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants, and reflect the personal views and opinions of the various contributors. They are not designed as models for submission to the examiner but rather as such discussion and explanation of the problems as will make their study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, October 1956

Accounting II, Question 6 (12 marks)

The M Co. Ltd. issued $100,000 4% ten-year bonds for $95,000 on December 31, 1953, with interest payable annually. All bonds are issued in denominations of $100 and are redeemable by the company at any time at a price of 104. The discount on issue of bonds is to be amortized on a straight-line basis.

The trust deed provided for annual payments by the company to the trustee commencing December 31, 1954, of a sum equal to 5% of the par value of the original issue. The money is to be applied by the trustee in the acquisition of the bonds for cancellation, either by redemption by lot at the stipulated redemption price of 104, or by purchase on the market at not more than the redemption price. Bonds so acquired are cancelled immediately.

The market price of the bonds was $99 on December 31, 1954 and $105 on December 31, 1955.

Required:

Set out in chronological order, the journal entries, complete with narratives, on the books of M Co. Ltd. to record the issue of bonds and the payment of interest, the payment to the trustee and the acquisition and cancellation of bonds by the trustee on December 31, 1954 and on December 31, 1955. Assume that, at both dates, bonds are available on the market for acquisition by the trustee.

A SOLUTION

BOOKS OF M CO. LTD.

		Dr.	*Cr.*
1953			
Dec. 31	Bank (general)	95,000	
	Discount on bonds	5,000	
	Bonds payable		100,000
	Issue of 4% ten year bonds		

		Dr.	*Cr.*
1954			
Dec. 31	Bond interest	4,500	
	Discount on bonds		500
	Bank (general)		4,000
	Payment of interest for year on bonds outstanding (4% of $100,000) and amortization of discount for one year:		

$$\frac{5,000}{10} = \$500.$$

		Dr.	*Cr.*
Dec. 31	Bank (trustee)	5,000	
	Bank (general)		5,000
	Annual instalment paid to trustee for redemption of bonds; 5% of $100,000.		

		Dr.	*Cr.*
Dec. 31	Bonds payable	5,000	
	Loss on redemption of bonds	175	
	Bank (trustee)		4,950
	Discount on bonds		225
	Purchase for cancellation of 50 bonds at 99.		
	Discount on bonds cancelled:		

$$\frac{5,000}{100,000} \times 4,500 = \$225$$

		Dr.	*Cr.*
1955			
Dec. 31	Bond interest	4,275	
	Discount on bonds		475
	Bank (general)		3,800
	Payment of interest for year on bonds outstanding (4% of $95,000) and amortization of discount for one year:		

$$\frac{4,275}{9} = \$475.$$

Dec. 31	Bank (trustee)	5,000	
	Bank (general)		5,000
	Annual instalment paid to trustee for redemption of bonds: 5% of $100,000.		

Dec. 31	Bonds payable	4,800	
	Loss on redemption of bonds	384	
	Bank (trustee)		4,992
	Discount on bonds		192
	Redemption by trustee of 48 bonds at 104.		
	Discount on bonds redeemed:		

$$\frac{4,800}{95,000} \times 3,800 = \$192.$$

Examiner's Comments

The most frequent errors in candidates' answers were:

1. Amortizing bond discount at December 31, 1955 at one-tenth of $5,000.
2. Incorrect calculation of loss on redemption.
3. Charging the loss on redemption to bond interest account.

PROBLEM 2

Final Examination, October 1956

Accounting III, Question 3 (17 marks)

M Co. Ltd. manufactures a single product and uses an estimated cost system. The monthly estimated unit costs are revised at the end of each month to correspond to the actual unit cost of production during the current month. The revised estimate is then used as the estimated unit cost in the recording of next month's operations. The closing inventories at the end of each month are adjusted to the currently revised estimates.

Based upon the revised estimate of the preceding month, the estimated unit cost for the month of June is:

Material	$25	
Labour	8	
Factory service — 2 machine hours @ $5	10	$43

The following information relates to the operations of the month of June.

(i) Work in process inventories:

	Material	*Labour*	*Factory Service expense*
June 1 — 80 units	100% complete	40% complete	40% complete
June 30 — 60 units	100% complete	70% complete	70% complete

(ii) Finished goods inventories:

June 1 — 70 units
June 30 — 20 units

(iii)	Material put into process, at actual cost	$12,900
(iv)	Labour put into process, at actual cost	$ 4,025
(v)	Factory service expense, at actual cost	$ 3,910
(vi)	Machine hours	962 hours
(vii)	Units sold	500 units

Required:

Journal entries, complete with narratives, to record the above information and to adjust the variations from estimate for the month of June to inventories and to cost of goods sold.

A SOLUTION

M CO. LTD.

Calculation of Production
for the month of June, 1956

	Materials	*Labour*	*Factory Service*	*Total*
Sales (units)	500	500	500	
Deduct				
Finished goods, June 1 (units)	70	70	70	
Work in process, June 1 (equivalent units)	80	32	32	
Equivalent units produced and sold during month	350	398	398	
Add				
Finished goods, June 30 (units)	20	20	20	
Work in process, June 30 (equivalent units)	60	42	42	
Equivalent units produced during month	430	460	460	
Estimated cost per unit	$ 25	$ 8	$ 10	$ 43
Estimated cost of production	$10,750	$3,680	$4,600	$19,030
Actual cost of production	12,900	4,025	3,910	20,835
Adjustment required	$ 2,150	$ 345	$ (690)	$ 1,805
Allocated as follows:				
Charge (credit) to cost of goods sold	$\frac{(350)}{(430)}$ 1,750.00	$\frac{(398)}{(460)}$ 298.50	$\frac{(398)}{(460)}$ (597.00)	1,451.50
Charge (credit) to finished goods inventory, June 30	$\frac{(20)}{(430)}$ 100.00	$\frac{(20)}{(460)}$ 15.00	$\frac{(20)}{(460)}$ (30.00)	85.00
Charge (credit) to work in process inventory, June 30	$\frac{(60)}{(430)}$ 300.00	$\frac{(42)}{(460)}$ 31.50	$\frac{(42)}{(460)}$ (63.00)	268.50
	$2,150.00	$345.00	$(690.00)	$1,805.00

BOOKS OF M CO. LTD.

Date	Account	*Dr.*	*Cr.*
June 1-30	Materials in process	12,900.00	
	Materials and supplies		12,900.00
	Actual cost of materials put into process		
June 1-30	Labour in process	4,025.00	
	Payroll — direct labour		4,025.00
	Actual cost of direct labour for month		
June 1-30	Factory service in process	3,910.00	
	Sundry accounts		3,910.00
	Actual cost of factory service for month		
June 1-30	Finished goods	19,350.00	
	Materials in process		11,250.00
	Labour in process		3,600.00
	Factory service in process		4,500.00
	Estimated cost of 450 units completed during month: 450 x $43 = $19,350		
June 1-30	Cost of goods sold	21,500.00	
	Finished goods		21,500.00
	Estimated cost of 500 units sold, at $43		
June 30	Adjustment account	1,805.00	
	Factory service in process	690.00	
	Materials in process		2,150.00
	Labour in process		345.00
	To adjust charges made to process accounts for month's production from actual to estimated cost, per schedule		
June 30	Cost of goods sold	1,451.50	
	Finished goods	85.00	
	Materials in process	300.00	
	Labour in process	31.50	
	Factory service in process		63.00
	Adjustment account		1,805.00
	To close Adjustment account and apportion balance over cost of goods sold, finished goods and work in process per schedule		

Examiner's Comments

1. Some candidates lost marks for not submitting their answers in the form of journal entries, as the problem required.
2. An alternative basis for the distribution of variances which was accepted was the percentage relationship between cost of closing inventories of finished goods and work in process and cost of goods manufactured.

EDITOR'S COMMENTS: An alternative approach would be to calculate, at the end of the month, the actual cost of production per unit put into process, and to transfer to Ad-

justment account whatever amount is required to restate the month-end balances in the inventory accounts at actual cost; and then closing Adjustment account to Cost of goods sold. The calculation and journal entries would be as follows:

	Process accounts		
	Material	*Labour*	*Factory service*
Units from process to finished goods	450	450	450
Equivalent units in process at end of month	60	42	42
Total units in production during month	510	492	492
Equivalent units in production at beginning of month	80	32	32
Equivalent units put into production during month	430	460	460
Actual cost of units put into production during month	$12,900	$ 4,025	$ 3,910
Actual cost per unit	$30	$8.75	$8.50

The following entries, made at the end of the month, would replace those dated June 30 in the solution above:

June 30	Adjustment account	1,536.50	
	Factory service in process	627.00	
	Materials in process		1,850.00
	Labour in process		313.50

To adjust balances in process accounts to actual cost at June 30, as follows:

	Balances unadjusted	*Actual cost*	*Adjustment required*
Material	$3,650.00	60 x $30 = $1,800.00	$1,850.00 Cr.
Labour	681.00	42 x $8.75 = 367.50	313.50 Cr.
Factory service	Cr. 270.00	42 x $8.50 = 357.00	627.00 Dr.

June 30	Finished goods	85.00	
	Adjustment account		85.00

To revise balance to actual cost at June 30

Actual cost 20 units at $47.25	$945.00
Unadjusted balance to date	860.00
	$ 85.00

June 30	Cost of goods sold	1,451.50	
	Adjustment account		1,451.50

To close Adjustment account

PROBLEM 3

Final Examination, October 1956
Accounting III, Question 4 (18 marks)

A Co. Ltd., a large retail food chain, has agreed to buy all the outstanding shares of B Co. Ltd. for $9,000,000. In order to finance the transaction, the directors of A Co. Ltd. consider the three following alternatives:

(i) To issue $9,000,000, 15-year, 4½% sinking fund debentures.
(ii) To issue $9,000,000, 5% cumulative redeemable preference shares.
(iii) To issue 300,000 common shares without par value at $30 each.

Condensed balance sheets as at December 31, 1955, and statements of profit and loss for the year ended on that date are set out below for each company:

CONDENSED BALANCE SHEETS
as at December 31, 1955

	A. Co. Ltd.	*B. Co. Ltd.*
Current assets	$15,000,000	$2,000,000
Fixed assets	10,000,000	2,000,000
	$25,000,000	$4,000,000
Current liabilities	$ 7,000,000	$2,000,000
Funded debt — 5% serial bonds — principal due $500,000 annually, 1956-65	5,000,000	nil
Common stock without par value:		
Issued—1,250,000 shares	3,500,000	
Issued — 250,000 shares		1,000,000
Earned surplus	9,500,000	1,000,000
	$25,000,000	$4,000,000

CONDENSED STATEMENTS OF PROFIT AND LOSS
for the year ended December 31, 1955

	A. Co. Ltd.	*B. Co. Ltd.*
Sales	$140,000,000	$30,000,000
Profit before the undernoted items	$ 6,550,000	$ 1,400,000
Depreciation	$ 1,300,000	$ 250,000
Interest on bonds	250,000	nil
Income taxes	2,344,600	535,100
	$ 3,894,600	$ 785,100
Net profit	$ 2,655,400	$ 614,900
Dividends	750,000	250,000
Carried to earned surplus for year	$ 1,905,400	$ 364,900

Required:

(6 marks) (a) Assuming the net profits of each company remain constant, calculate the consolidated net profit per common share outstanding which would result under each of the three alternatives.

(4 marks) (b) Calculate the additional annual cash outlay required for each of the three alternatives, assuming that the rate of dividends on common shares will be the same as in 1954.

(8 marks) (c) Discuss the advantages and disadvantages of each of the three alternatives.

A SOLUTION

A. CO. LTD.

Alternative Plans for Financing Purchase of Shares of B. Co. Ltd.

(a) **Calculation of consolidated net profit per share**

	Alternatives		
	Bonds	*Preferred shares*	*Common shares*
Profit A. Co. Ltd.	$2,655,400	$2,655,400	$2,655,400
Profit B Co. Ltd.	614,900	614,900	614,900
	3,270,300	3,270,300	3,270,300
Additional bond interest	(405,000)		
Preferred dividends		(450,000)	
Profit available for common shares	$2,865,300	$2,820,300	$3,270,300
Number of common shares outstanding	1,250,000	1,250,000	1,550,000
Consolidated net profit per share	$2.29	$2.26	$2.11

(b) **Additional Annual Cash Outlay Required**

(i) Issue of sinking fund debentures		
Annual payment of interest	$405,000	
Annual payment to sinking fund $\frac{\$9,000,000}{15}$	600,000	
		$1,005,000
(ii) Issue of cumulative redeemable preference shares		
Annual dividend requirement		$ 450,000
(iii) Issue of common shares without par value		
Annual dividend requirement — 300,000 shares at 60c per share		$ 180,000

(c) Advantages and Disadvantages of Alternative Plans

1. *Effect on profit per common share*

Either the proposed issue of debentures or of preferred shares will provide a greater profit per share than the proposed issue of common shares. Other things being equal, a higher profit per share will make for good stockholder relations to the extent that it affects dividend policies and market price of the stock.

2. *Effect on working capital*

The issue of debentures will cause a heavy drain on the working capital of A Co. Ltd., which will be offset in part only by dividends received from B Co. Ltd. Even if all the profits of B Co. Ltd. were distributed in dividends, these would amount to only $600,000 received by A Co Ltd., compared with a cash outlay of $1,005,000 in respect of the new debentures in the earlier years.

The issue of preference shares would require a much smaller annual cash outlay ($450,000) and the issue of common shares, only $180,000. The dividend on the common shares could be met out of the present dividend paid by B Co. Ltd.

3. *Stability of earnings*

If the plan to issue debentures is adopted, it will be important that the earnings should be stable. The increase in working capital attributable to the operations of the two companies would, from the point of view of A Co. Ltd., be:

Profit, after bond and debenture interest	$2,250,400
Add back depreciation recorded	1,300,000
	$3,550,400

plus whatever dividends would be received from B Co. Ltd. The working capital required for the present bond issue and the proposed debentures would be:

	Interest	*Debt reduction*	*Total*
5% serial bonds	$250,000	$500,000	$ 750,000
4½% sinking fund debentures	405,000	600,000	1,005,000
			$1,755,000

In subsequent years, the net annual interest cost will be reduced, however, as the principal of the serial bonds is reduced and the sinking fund accumulates.

By contrast, the payment of dividends on the proposed issue of common shares would be within the discretion of the directors, subject to the consideration that it should be possible to justify their amount to the shareholders.

The issue of preference shares would offer a compromise since dividends need not be paid in times of adversity or inadequate working capital, but they must be paid before any common dividends are paid.

Editor's discussion of solution: If the debentures were issued, it would not be possible for A Co. Ltd. to deduct the interest cost in computing its taxable income, by section 11(1)(c) of the Income Tax Act. That section reads:

S. 11(1)(c) – Notwithstanding [s. 12(1) (a) (b) and (h)], the following amounts may be deducted in computing the income of a taxpayer for a taxation year: . . . (c) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on

(i) borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt), or

(ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt),

or a reasonable amount in respect thereof, whichever is the lesser.

Since the proceeds of the debenture issue would be used to acquire property in the form of shares in B Co. Ltd., and the income from this investment, being dividends received from a taxable Canadian company, would be exempt, the interest paid on the debentures would not be a deductible expense of A Co. Ltd.

Examiner's Comments

1. A considerable number of candidates were not familiar with section 11(1)(c) of the Income Tax Act.
2. Some candidates added the subsidiary's shares to those of the parent company when calculating the consolidated profit per share.
3. The following treatments were considered acceptable in solutions submitted:
   a) Adjusting the consolidated profit figure for the fact that the subsidiary company would lose the lower rate of tax on the first $20,000 on consolidation.
   b) Reducing the additional annual cash outlay by the dividend received from B Co. Ltd. ($250,000).

PROBLEM 4

Final Examination, October 1956
Accounting III, Question 5 (10 marks)

The profit before taxes on income for the year ended December 31, 1955 of L Manufacturing Co. Ltd., as shown by the statement of profit and loss, amounted to $65,000.

The following items were included in the statement of profit and loss:

(i)	Dividends received from taxable Canadian corporations	$ 8,000
(ii)	Interest income on investment in industrial bonds, including $450 amortization of discount on purchase	2,350
(iii)	Loss on sale of investments	1,500
(iv)	Legal fees, including $2,000 incurred in acquiring land and $3,000 incurred in connection with an issue of shares	5,000
(v)	Interest on company's funded debt, including $6,000 amortization of bond discount	20,000
(vi)	Premium on life insurance on the president less the increase of $400 in the cash surrender value thereof since December 31, 1954 (company is the beneficiary)	565
(vii)	President's annual membership fee in a golf club	300
(viii)	Retirement allowance to former employee	2,400
(ix)	Provision for future capital expenditures	15,000
(x)	Fees paid to a firm of management consultants and industrial engineers in connection with the reorganization of the factory operations	4,000
(xi)	Donations to charitable organizations	6,300

The company commenced operations in 1949. The annual income or loss, as agreed with the tax authorities, was as follows:

	Income	Loss
1949	$10,000	
1950		$195,000
1951	22,000	
1952	40,000	
1953	50,000	
1954	65,000	

Required:

A statement reconciling the profit of L Manufacturing Co. Ltd., as shown by the statement of profit and loss, with its taxable income for the year ended December 31, 1955, as defined by the Income Tax Act.

A SOLUTION

L MANUFACTURING CO. LTD.

STATEMENT OF TAXABLE INCOME
for the year ended December 31, 1955

Profit for year before taxes on income, per books				$ 65,000.00
Add back items charged to operations which are not allowed as deductions for tax purposes				
Loss on sale of investments			$ 1,500.00	
Legal fees incurred in acquiring land			2,000.00	
Amortization of bond discount			6,000.00	
Portion of premium on life insurance policy charged to operations			565.00	
Membership fee in golf club			300.00	
Provision for future capital expenditures			15,000.00	
				25,365.00
				90,365.00
Deduct amortization of discount on bond investments				450.00
				89,915.00
Add back charitable donations paid				6,300.00
				96,215.00
Deduct charitable donations allowed (5% of $96,215)				4,810.75
				91,404.25
Deduct dividends from taxable Canadian corporations			8,000.00	
Loss carry over:				
1950 loss		$195,000		
1949 profit	$10,000			
1951 profit	22,000			
1952 profit	40,000			
1953 profit	50,000			
1954 profit	65,000			
		187,000		
			8,000.00	
				16,000.00
Taxable income for year				$75,404.25

C. I. C. A. ANNUAL CONFERENCE 1957

Living up to all predictions, the 55th annual conference of The Canadian Institute of Chartered Accountants, attended by more than 500 members and their guests, not only maintained past standards but established new marks in the calibre of both technical and social events.

A reception held in the gaily-decorated Bessborough Hotel Ball Room on the evening of Sunday, August 18, served as the official social opening of the conference. The warmth and success of this and other gatherings over the next three days could perhaps be attributed to the contagious friendliness of the Saskatoon welcoming committees.

Chairman of Monday morning's opening ceremonies was R. C. Hodsman, president of the Saskatchewan Institute. Mayor McAskill of Saskatoon led off proceedings with a warm welcoming address, followed by the C.I.C.A. president's report presented by W. Givens Smith, F.C.A.

In his report, Mr. Smith concentrated on the challenges in student and post-graduate training that the profession must face in gearing itself to meet the growing complexities of Canadian business. He said in part:

> At our present rate of growth, we can look forward to at least 14,500 members in 1967. There is and will continue to be, I am convinced, increasing demand for the services of those with the training and skills we are able to give them.
>
> Those of us who are endeavouring to interest the right type of young person in a future of accountancy are finding it increasingly difficult to compete with industry for commerce graduates and while, in some instances, it has been a case of being priced out of the market, this is not nearly the whole story.
>
> Possibly we should stand back and look at our overall training requirements. In addition to a university degree, is our term of service the right one? Should we have four examinations over a five-year term after matriculation standing, and is a five-year course of study necessary? Are we trying to make our graduates specialists in too many lines? We must consider the fact that our present system is not necessarily the right one because it has been so in the past.

Pointing out the relationship of possible changes in educational procedures to the work of the Committee on Cooperation with Other Accounting Bodies, Mr. Smith said that one of the key methods of demonstrating leadership in our field was to cooperate in whatever ways are open to us with the other accounting and auditing associations and, particularly, with those teaching in these areas.

With regard to the challenges to be expected in the way of research, Mr. Smith said:

> One of the ways we demonstrate that we are in truth a profession is the vigour with which we promote our arts and skills. Through the excellent work of our Research Committee and the director and his staff, we are now producing bulletins, monographs on special subjects and much other literature which must not only increase the knowledge of

the individual member but improve the quality of his work and promote uniformity. Among other advantages, our bulletins raise the standards of presentation and disclosure and weld the profession together through adherence to common standards.

I mentioned previously that possibly we were endeavouring to make our students specialists in too many fields. I think this is so but the practitioner finds that his activities eventually cover taxation, cost accounting, advising on installation of accounting systems and machines, stock controls, financial advice for many different businesses, bankruptcy, liquidation and many more. If we are to give the greatest possible assistance to our members, I feel we must seek to arrange post graduate study in these and other fields. This is not something that can be done easily or in a short time. The profession will first have to demonstrate the need, assure our educational institutions of adequate support and then assist in planning and possibly in staffing of post-graduate courses.

In closing, Mr. Smith mentioned that, after having served a year as C.I.C.A. president and five years on the executive, he probably found it a little easier to express these opinions on the needs of the profession but pointed out, at the same time, that he had not lost sight of the Institute's accomplishments.

I believe we can be very proud of a more than creditable effort in the field of research, successful influencing of tax legislation, development of an interesting and educational annual conference, the moulding of 10 separate Provincial Institutes into one national body, and an excellent magazine. The extent of our future pride lies directly in the hands of those we elect to leadership in the Provincial and Canadian Institutes. They must be able to plan not just for today, but for the many years ahead.

The morning session concluded with Walter L. Gordon delivering the keynote address, "The Challenge of Diversification". The text of Mr. Gordon's address can be found on pages 315 to 322 of this issue.

At the members' luncheon on the same day, E. C. Leslie, Q.C., president of the Canadian Bar Association, spoke of the friendly relations that exist between the C.I.C.A. and his professional association. Mr. Leslie felt that through collaboration on such projects as the Canadian Tax Foundation and the joint income tax brief to the federal government, the two bodies had also helped to strengthen the relationship between the individual lawyers and accountants.

Head table guests at the luncheon included Mayor McAskill, T. H. McLeod, Dean of the College of Commerce, University of Saskatchewan, John H. Zebley, immediate past president of the American Institute of Certified Public Accountants, and Edwin C. Harris, winner of the Governor-General's Gold Medal.

The technical program for C.A.'s both in industry and practice was provided bv the four panel discussions which took place on Monday afternoon. Topics covered were "What the Business Community Expects from Audited Financial Statements", "Team-Work in Estate Planning", "Accounting Problems in the Oil Industry", and "How Small Firms Can Best Serve Their Clients".

On Monday evening, members and their ladies were taken by bus to the Western Development Museum where a selection of old-time thrashers, binders and separators were put through their paces. After the "live" part of the show, the guests strolled

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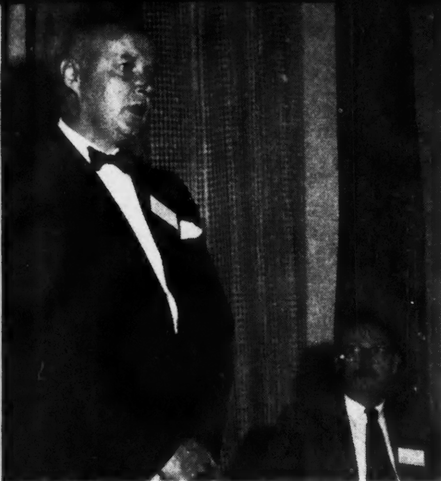

Howard I. Ross, speaking on "The Modern Approach to Auditing".

J. J. Macdonell, speaking on "The Professional Practice of Management Advisory Services".

R. C. Hodsman, president of the Saskatchewan Institute, welcoming the members on the opening day.

R. N. A. Kidd, chairman of the Board of Examiners-in-Chief of the Provincial Institutes, presents Edwin C. Harris with the Governor-General's gold medal.

A PANEL ON "ESTATE PLANNING"
Left to right: W. H. Broughall, National Trust Co.; L. E. Fingarson, C.A.; A. D. Stanley, C.A.; C. G. Schmitt, Q.C., Saskatoon; D. Lawton, C.L.U., Great-West Life Assurance Co., Edmonton.

BETWEEN SESSIONS

Left to right: George Cumpston, Vancouver; Eric Wiles, Seattle, immediate past president of the Washington C. P. A. Society; George Keeping, Montreal; Frank Thurmeier, Saskatoon.

Left to right: Mr. and Mrs. R. C. Hodsman and Mr. and Mrs. W. G. Smith receive Mr. and Mrs. C. J. Kirkpatrick, Saskatoon, at the opening reception.

Presentation of luggage to retiring president W. G. Smith by incoming president J. A. de Lalanne at the closing dinner.

Left to right: J. A. Wil son, Toronto; L. G Crawford, Niagara Fall Geo. Spence, Toronto; I Robinson, Regina.

Roy Busche and Mr. an Mrs. H. Crosby, all o Halifax, view antiqu steam-driven thrasher the Western Develop ment Museum.

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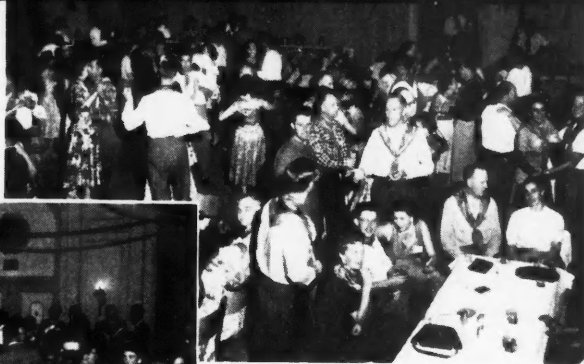
formal evening at Saskatoon Badminton Club. Every member was given a gaily-coloured neckerchief.



Opening reception in the Ball Room of the Bessborough Hotel.

TOUR OF FORESTRY FARM
Left to right: Mrs. J. Hill, Toronto; Mrs. W. I. Hetherington, Toronto; Mrs. R. L. Cordingley, Edmonton; Mrs. J. G. Duncan, Edmonton.

The Get-Acquainted Tea at the Bessborough Hotel. Golden-wheat and fire-red Saskatchewan lilies form an attractive centrepiece.

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Arrival of coaches at Murray Memorial Library, University of Saskatchewan.

through the building looking at antique room settings and farm relics. Later, members and their ladies attended an informal dance and buffet supper at the Saskatoon Badminton Club as guests of the Saskatchewan Institute. As each person came on to the dance floor, he was given a brightly coloured souvenir scarf. Shedding of jackets and ties was compulsory and the orchestra mixed fox trots with the "butterfly" and other Western dances.

On the morning of Tuesday, August 20, two excellent papers titled "The Professional Practice of Management Advisory Services" and "The Modern Approach to Auditing" were delivered by J. J. Macdonell and Howard I. Ross respectively. The text of these addresses appear in this and succeeding issues.

The business session on Tuesday ended with the annual general meeting of members, the reports of Council and the treasurer and the re-election of the auditors.

At luncheon on Tuesday, the members were the guests of the Province of Saskatchewan with the Honourable C. M. Fines, Provincial Treasurer, as speaker. Applying the conference theme to Saskatchewan's future, Mr. Fines said that it was because of diversification in many forms that the grim history of the 1930's can never be repeated in that province. This was so, he stated, because, although agriculture was still the backbone of the province's economy, the significant fact was that the buffers in the economy — the non-farm enterprises — were now substantial enough to introduce a new element of stability.

Tuesday afternoon was devoted to golf, with the men playing at the Riverside Course and the ladies at the Saskatoon Municipal Course. Three trophies were up for competition and the winners were L. E. Cartwright, Winnipeg, low net score; H. Robinson, Calgary, low gross score; and the Alberta Institute, best team score.

The beautiful University of Saskatchewan provided the necessary academic atmosphere for Wednesday morning's eight technical discussion groups and the afternoon's panel discussion on taxation, followed by the conference roundup panel.

W. Givens Smith presided over the closing dinner and dance on Wednesday evening at the Bessborough Hotel.

Paying tribute to all those who had been associated with him during his term as president, Mr. Smith called special attention to the task so efficiently handled by the Annual Meeting Program Committee under the joint chairmanship of C. W. Leach and George Patrick. The retiring president then introduced the incoming president, James A. de Lalanne of Montreal. In closing, Mr. de Lalanne presented Mr. Smith with a matched set of luggage.

In addition to the mixed social gatherings, the ladies had a program of their own that included coffee parties, a get-acquainted tea, golf, a luncheon at the picturesque Saskatchewan Forestry Farm and a tour of the city that ended with a visit to the new Murray Memorial Library on the University campus.

The social side of the conference was in perfect keeping with the high calibre of the technical sessions and the success of this convention is certainly a "challenge" to all conferences in the future.

NEWS OF OUR MEMBERS

Alberta

Moran, Fenton & Bliss, Ernest Mainwood & Stewart W. Andrew, Chartered Accountants, announce the merger of their practices. Henceforth the practice of their profession will be carried on under the firm name of Moran, Fenton, Bliss & Co., Chartered Accountants, with offices at 353-11th Ave. S.W., Calgary.

British Columbia

Rickard, Crawford & Co., Chartered Accountants, announce the opening of an office for the practice of their profession at 300A – 1st St. W., Revelstoke.

Roberts, Munro & Co., Chartered Accountants, announce the acquisition of the practice of Raymond P. Dewar, C.A., Victoria.

Gordon G. Williams, B.Com., C.A., and Sam W. Wilson, C.A. announce the formation of a partnership for the practice of their profession under the firm name of Williams & Wilson, Chartered Accountants, with offices at Lakeview Credit Union Bldg., Box 1811, Dawson Creek.

Roy A. Shand, C.A. announces the removal of his office to 1815 West 7th Ave., Vancouver.

Price, Waterhouse & Co., Chartered Accountants, Vancouver, announce the admission to partnership of Archie D. Russell, C.A.

Ontario

George Irvine, C.A. has been appointed comptroller of Thompson Products Ltd., St. Catharines.

Thos. L. Redfern, C.A., and Gerald Murray, C.A. announce the formation of a partnership for the practice of their profession under the firm name of Redfern, Murray & Co., Chartered Accountants, with offices at 8 Brock St. W., Tillsonburg.

Ages, Agulnik & Co., Chartered Accountants, announce the removal of their offices to Ste. 208-9, 102 Bank St., Ottawa.

Samuel H. Cohen, C.A., and Morton W. Perlman, C.A. announce the formation of a partnership for the practice of their profession under the firm name of Cohen, Perlman & Co., Chartered Accountants, with offices at Ste. 308, 88 Richmond St. W., Toronto.

D. L. Storey, C.A. has been appointed comptroller of Henry K. Wampole & Co. Ltd., Perth.

Geoffrey H. Ward, C.A. and W. John Aldersley, C.A. announce the formation of a partnership for the practice of their profession under the name of Ward and Aldersley, Chartered Accountants, with offices at Hanover. Mr. Ward will continue to maintain his office at 200 Bay St., Toronto.

Quebec

Rohrlich, Routtenberg, Scharf, Kwiat & Ginsberg, Chartered Accountants, announce the retirement from partnership of Arthur A. Rohrlich, C.A., and the admission to partnership of M. Martin Rohr, C.A. and Ronald Singer, C.A. The practice will continue under the firm name of Routtenberg, Scharf, Kwiat & Ginsberg, Chartered Accountants, Montreal.

Henry S. Pesner, C.A. announces the removal of his office to Ste. 302, 10 St. James St. W., Montreal.

Wm. D. Sumner, C.A. announces his association with Ernst & Ernst, with offices at Ste. 750, 630 Sherbrooke St. W., Montreal.

INSTITUTE NOTES

ONTARIO INSTITUTE

Instructors for C.A. Course: Queen's University is interested in hearing from chartered accountants in Ontario who would like to correct students' lesson exercises in the C.A. Course. The work carries with it a remuneration based on the number of exercises marked, and many members have found it a useful means of supplementing income. Anyone interested should contact the Ontario Institute indicating any preferences as to the type of lessons or years of the course which he would like to mark.

There is also a need for lawyers to correct the law lessons in the course. Any member who knows of a young lawyer who might undertake this type of work is asked to pass his name along to the Institute.

QUEBEC INSTITUTE

Seventh International Congress: Quebec Institute members who attended the congress in Amsterdam included J. R. Church, J. A. deLalanne, G. P. Keeping and R. N. A. Kidd.

Council Meeting: The August meeting of the Quebec Institute Council was held at the Royal Quebec Golf Club in Boischatel, near Quebec City, the Quebec City Committee being hosts at the luncheon. The luncheon was followed by a golf tournament. The Institute cup for the best net score (18 holes) was won by Jean Paul Roy of Levis. The Samson cup for the best net score (9 holes) was won by Donald Fortier of Quebec. The latter cup was donated this year by Maurice Samson.

Committee Representatives: The following have been appointed representatives on C.I.C.A. committees: magazine and publications, D. F. Rennie; government accounts, Rosaire Courtois; public relations; panel, J. S. McKeown; Regulatory Legislation Panel, M. Laird Watt. To Provincial Institutes Committees appointments are as follows: education and examinations, Peter S. Leggat; sub-committee on courses of instruction, R. N. A. Kidd; board of examiners-in-chief, Victor Houghton and Marius Laliberté.

HAMILTON & DISTRICT STUDENTS

The annual fall dance of the Hamilton and District Chartered Accountants Students Association will be held on Friday, November 8, 1957 in the Ebony Room at Robert's Restaurant, King St. E., Hamilton. Dancing will be from 8.30 p.m. to 1.00 a.m. to the music of Chris Lovett and his orchestra.

The editor welcomes information for this column. News of members and provincial Institutes' activities received up to and including the 13th of the month will appear in the following issue of the journal.

C.I.C.A.
MEMBERS DIRECTORY

The 1957-58 edition of the Directory of Canadian Chartered Accountants is now off the press. To be sure of getting your copy of this 300-page book, place your order today.

In addition to complete listings of 7500 members by province, there is an alphabetical listing for quick easy reference.

Another useful feature is an up-to-date geographical listing of all firms and sole practitioners, showing names of resident partners and principals.

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CLASSIFIED ADVERTISEMENTS

Rates: *Positions wanted, $7.00 per column inch; Positions offered, $10.00 per column inch; Open rate, $17.00 per column inch.*

All replies to box numbers should be sent to The Canadian Chartered Accountant, 69 Bloor Street East, Toronto 5, Ontario.

Closing date is 14th of preceding month

COMMONWEALTH CITIZEN (PAKISTANI) — age 22, university graduate (B.Com. with major in a/c) seeks articled-studentship with C.A.'s. Exemption from F.Y. course and reduction in articles by one year (4 yr.), obtainable. Adequate allowance expected (about $138 p.m.). Available by plane (own expense) in 10 days. Please write, M. M. Khan Daem-Manzil, A.M. 6, Hashimgazdar Road, Karachi - 1.

PAKISTANI: B.Com., 20 years, staying in London, U.K. seeks articleship in Canada. Salary expected. Box 698.

OPPORTUNITY for recent graduate or senior student with an expanding firm of chartered accountants in Northern Ontario. Excellent opportunity for future partnership. Reply in strict confidence. Box 699.

SOLELY PRACTISING MONTREAL A.P.A., 52, with good and growing clientele, seeks office facilities with C.A. firm with the view of eventually selling or merging his practice with an agreement of succession. Box 697.

PRACTICE WANTED: Toronto firm of chartered accountants with connections in Western Ontario wishes to acquire practice in the London-Windsor area. Box 705.

CHARTERED ACCOUNTANT B.Com., age 27, single, seeks permanent position with practising firm in Calgary offering prospects of partnership arrangement. Box 696.

COMPTABLE AGREE bilingue, pratiquant seul, désire acheter clientèle complète ou partielle ou former société en vue de succession. Montréal et environs. Boîte 702.

ACCOUNTANT: Major industry in Northern Ontario requires young man with accounting degree or equivalent experience to work in the development of cost accounting methods and procedures. Exceptionally interesting position with a large scope and good prospects for advancement. Replies will be treated in confidence. Box 695.

ACCOUNTING PRACTICE WANTED: Chartered accountants are interested in purchasing an established accounting practice in Metropolitan Toronto or surrounding area. Substantial down payment available. All replies considered. Box 700.

WANTED by very ambitious public accountant age 29, Toronto area preferred.
(1) position with chance to build own practice re future partnership or
(2) per diem work ($20 per day) or
(3) job in industry ($6,000 min.)
I have ability.
I can work long hours.
I can start November 1st. Box 701.

C.A. STUDENT, Jewish, writing final examination in October, wishes position with practising firm in Toronto. Box 703.

FIFTH YEAR STUDENTS: If you are writing your final examination and have good reason to expect to be successful, and are planning a career in public practice, a Toronto chartered accountant, established for a good number of years, is looking for such a person of ability who is willing to assume responsibility and with a view to eventually becoming a member of the firm. Apply at once giving full particulars of experience, background, age, marital status and references. Box 704.

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